PROCEEDINGS OF THE INTERNATIONAL CONFERENCE ON EAST ASIAN DEVELOPMENT:

Lessons for a New Global Environment

Kuala Lumpur, Malaysia
29 February - 1 March 1996

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PREFACE

At its forty-first session held in Geneva in September 1994, the Trade and Development Board agreed that there should be a follow-up to the research carried out by the UNCTAD secretariat on the development experiences of East Asia (published in the *Trade and Development Report, 1994*) and to the Board's own deliberations on the subject. There was broad agreement that the process of rapid outward-oriented industrialization which underpinned the region's achievements included a well-defined role for government policy. Yet, elements in understanding were still missing. Furthermore, it was recognized that any policy lessons needed to be tailored to changes in the international environment, most of all those arising from the agreement to establish the World Trade Organization.

In accordance with the planned activities of the project on "East Asian Development: Lessons for a New Global Environment", a Conference was held in Kuala Lumpur, Malaysia, on 29 February and 1 March 1996, in collaboration with the Institute of Strategic and International Studies (ISIS), Malaysia. The UNCTAD secretariat had undertaken substantive preparations for the Conference in the form of background studies by individual staff members and consultants and a secretariat report synthesizing the findings of the research (see the list of the background studies).

Although there is general agreement on some of the broader features which allowed the East Asian economies to make a successful transition from natural resource-dependence to labour-intensive manufacturing, and then to more sophisticated manufacturing industries essential for attaining high standards of living, many of the details remain a source of ongoing discussion and contention. UNCTAD's research has not avoided controversial positions in seeking to push this debate further and to sharpen its relevance for policy makers in other developing countries. But it has avoided drawing simple or mechanical lessons by recognizing the diversity of experiences in the East Asian region. At the same time, it has opened the analysis to a number of important areas ignored or downplayed in the now voluminous literature on East Asian development. Three areas in particular animated the discussion at the Conference.

Firstly, with respect to internal resource mobilization, UNCTAD's research confirms the role of raising domestic savings in fuelling rapid growth in East Asia. But such efforts have also been accompanied by measures to channel these resources towards investments leading to long-term productivity growth. This has not required very selective policies in the initial stages of industrial transition, but even the various macroeconomic instruments used to strengthen domestic capital formation have been complemented by effective monitoring, and on occasion disciplining, of those undertaking the investments. However, as economies moved beyond initial comparative advantages, more selective policies aimed at supporting particular industries and building up specific technological skills have become more important.

Secondly, in almost all cases a stronger investment regime has been closely linked to export-oriented development strategies. The policies pursued to promote exports in East Asia have been broadly in line with those from other development experiences. However, one important element which has distinguished East Asia is the close regional linkages which have been built across economies at different levels of development. Building these linkages has been an important part of industrial policy in the region. While the changing international trading environment may be more restrictive than before in allowing developing countries to conduct export-promotion policies, UNCTAD's research suggests there still remains considerable scope for replication of the East Asian experience in various areas.

Thirdly, the development strategies conducted by East Asian Governments do not fit neatly into a simple market-driven or state-driven recipe for rapid growth and economic development. Rather, a supportive institutional environment requires a competent public sector able to facilitate cooperation between policy makers and the private sector. Such institution-building is a daunting task for many developing countries. However, countries currently facing this institutional hiatus may take heart from the conscious efforts that have led to appropriate bureaucratic and institutional arrangements in East Asia.

The Kuala Lumpur Conference was attended by about 80 policy makers, academics and senior economists principally from the South East Asian region as well as from other regions, together with representatives of international organizations. It is hoped that this volume accurately reflects the major elements of discussion in the Conference. Unfortunately, some participants at the Conference did not submit their written statements to the UNCTAD secretariat, so it has not been possible to reproduce their interventions in these Proceedings.

One of the most important concerns to emerge from the discussion at the Conference was the relevance and replicability outside the region of various policy measures and institutional reforms taken in East Asia. In this context, it was felt that UNCTAD's work on East Asia needed to become more closely connected with the efforts of policy makers in other developing regions, particularly Africa, both to disseminate the findings arising from the Conference to a wider audience and to solicit responses to its relevance and replicability in the light of different development experiences. Such efforts are being undertaken.

The UNCTAD secretariat is currently engaged in a project of "Economic development and regional dynamics in Africa", with the overall objective of drawing on the experiences of East Asian economies, to identify action-oriented development strategies for Africa which will promote investment and exports, as well as stimulate regional dynamics, particularly in Southern Africa. This work will be presented to an African Development Conference, tentatively scheduled to be held in 1998.

On behalf of the UNCTAD secretariat I should like to thank all the participants in the Kuala Lumpur Conference for their valuable contributions. I should also like to express our deep appreciation to the Government of Japan for its support of these activities. Finally, my thanks also go to ISIS, Malaysia, which was our efficient local counterpart for the Conference.

R Ricupero

Rubens Ricupero
Secretary-General of UNCTAD

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Opening session

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Greeting by *Issei Nomura*, Ambassador of Japan to Malaysia

Welcoming remarks by *Tan Sri Zainal Abidin Sulong*, Chairman of the Institute of Strategic and International Studies (ISIS), Kuala Lumpur, Malaysia

Keynote address by *Y.B. Kerk Choo Ting*, Deputy Minister of International Trade and Industry, Malaysia

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* Written statement unavailable.

Greeting

*Issei Nomura**

His Excellency, Mr. Kerk Choo Ting, Deputy Minister of International Trade and Industry of Malaysia; Tan Sri Zainal Abidin Sulong, Chairman of ISIS; Mr. Roger Lawrence, Deputy to the Secretary-General of UNCTAD; distinguished guests; ladies and gentlemen.

It gives me great pleasure to make a few remarks on behalf of the Japanese Government at the opening session of the Conference on East Asian Development: Lessons for a New Global Environment. This Conference is indeed designed to examine East Asian development experiences from various angles and consider the applicability of the lessons derived from such experiences to other regions of the world under the new international economic environment characterized by liberalization and globalization. I believe that having a conference on this topic at this point in time has particular relevance in three different but interrelated contexts. In view of such relevance, the Japanese Government has offered a financial contribution to this Conference.

First of all, it would be highly beneficial to gain deeper understanding of the nature of East Asian development experiences as a result of this Conference. It is certainly true that a great deal has been discussed on this topic in recent years, particularly after the publication of *The Asian Miracle* by the World Bank, but we have not yet studied in full the applicability of the East Asian experiences that have made such dynamic and sustained economic development possible here in this region to elsewhere in the world. If this Conference provides further insight into this interesting question, it will constitute a significant contribution. What is to be noted about this Conference is that it addresses not only government initiatives for development but also regional dimensions of development. Furthermore, the Conference also looks at policies designed for marginalized sectors such as agriculture and small- and medium-scale enterprises. I am confident that such a pluralistic approach could provide materials for a better understanding of the issue. In this context, I am pleased to inform you that we are sponsoring another symposium, which will be held again in Kuala Lumpur in just one week's time, to discuss the "Asian miracles" and ways to promote further economic development in this region with effective regional cooperation. The symposium is due to be co-organized by the Institute of Strategic and International Studies (ISIS), Malaysia, and the Japan Institute of International Affairs.

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* Ambassador of Japan to Malaysia.

Secondly, when we discuss development issues, it is increasingly important to take into account the impact of the new world economic environment. In fact, many of the developing countries have been engaged in structural adjustment efforts designed to promote free market economy. In the international context, the Uruguay Round agreements have set rules and procedures for free trade. This new situation requires a closer examination as to which policy initiatives employed by East Asian countries are applicable under the new circumstances. In other words, future government initiatives and policies need to be geared more towards the creation or promotion of market conditions than towards restrictions on market functions. In this context, it is particularly important that this Conference proposes policy options in this new global environment.

Last but not least, I should like to point to the timeliness of this Conference. In fact, it is being held almost back to back with UNCTAD IX, to be held in South Africa from the end of April. UNCTAD IX is expected to discuss new development strategies under the prevailing economic trend of liberalization and globalization. The outcome of this Conference will surely be a useful input for UNCTAD IX.

It is certainly true that there is no single path towards development. But the recent success of emerging economies has created opportunities for less advanced economies to learn from the experiences of developing countries in the more advanced stages. This new pattern of cooperation is sometimes called South-South cooperation, and it is the policy of the Japanese Government to assist international efforts in this direction. One of the most typical examples of South-South cooperation is our initiative to promote dialogue and cooperation between Asian and African countries, which started with the Tokyo International Conference for African Development (TICAD) in 1993. Our support for the present Conference is in line with this policy initiative, and the Japanese Government intends to strengthen such support in the years to come.

Finally, let me express my deep gratitude to the UNCTAD secretariat and the Institute for Strategic and International Studies for their organization of this Conference and to all the participants for their highly appreciated participation. I am confident that the discussions ahead will produce an interesting and useful insight into this important topic.

Thank you very much. ■

Welcoming remarks

*Tan Sri Zainal Abidin Sulong**

The Honourable Mr. Kerk Choo Ting, Deputy Minister of International Trade and Industry of Malaysia; Mr. Roger Lawrence, Deputy to the Secretary-General of UNCTAD; His Excellency Mr. Issei Nomura, Ambassador of Japan to Malaysia; ladies and gentlemen.

It is with great pleasure that I, on behalf of the Institute of Strategic and International Studies (ISIS), Malaysia, welcome all of you to this Conference on East Asian Development. In particular, I would like to extend our greetings to the participants from overseas, many of whom are visiting Malaysia for the first time. *Selamat Datang!* We hope you will take some time off from your intellectual pursuits to explore Malaysia.

I believe the subject of this Conference - "East Asian Development: Lessons for a New Global Environment" - continues to be relevant for all of us. Although numerous seminars, conferences, books and papers on the subject have been presented over the last few years, and will not doubt continue to be presented, the subject is by no means exhausted. This is simply because the world economy, including East Asia, is not static but dynamic.

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* Chairman of the Institute of Strategic and International Studies (ISIS), Kuala Lumpur, Malaysia.

East Asia is still developing, still changing. There will always be new lessons to be learnt from the East Asian experience. For instance, the original "dragons" of Japan, the Republic of Korea and Taiwan Province of China have witnessed, over the last few years, profound changes not only in economic terms, but especially in the social and political spheres, and these new developments provide further lessons for other countries. Even so, the development track record of the East Asian economies will continue to be re-assessed by scholars, who will keep asking the question: *"How do we explain the rapid growth of the East Asian economies?"* We should welcome these fresh insights into the East Asian development story.

The world economy is constantly being transformed. There will not only be more players in international trade, but the international rules of the game are being continuously revised to reflect changing circumstances. Globalization of production, for instance, is one of the key forces driving the world economy today and this has implications for governments when formulating economic policies and in evaluating lessons from East Asian development for implementation in their own countries. The strengthening of the GATT/WTO system and the incorporation of new issues such as services, agriculture, investment rules and intellectual property rights within the multilateral trading regime will condition some of the policy lessons that can be learnt from the East Asian experience.

Indeed, the new "tigers" of East Asia - the ASEAN countries, Malaysia included, as well as China - clearly demonstrate that the lessons from Japan, the Republic of Korea and Taiwan Province of China must be modified not only to suit each country's unique domestic social, economic and political environment, but must also respond to ever changing international circumstances. The policy lessons of East Asian development are, therefore, not carved in stone: they must reflect the realities in which each country finds itself. While countries, especially small developing ones, may find it difficult to change the international environment, each should be able to ensure that its domestic environment is as conducive as possible to growth and development in the way the East Asian states have done.

The East Asian experience is thus the experience of diverse countries, each with its unique domestic circumstances. While we try to extract some common lessons from the East Asian development experience for other countries, this diversity of experiences and policy lessons should not be ignored. It is this diversity which allows the East Asian experience to offer lessons to a wide variety of developing countries, each with their own unique circumstances, needs and interests.

I will not touch on these issues in greater detail because the Honourable Deputy Minister of International Trade and Industry will be speaking on this very theme - *The East Asian development model: Its relevance in a changing world economy* - in his keynote address to the Conference. I am confident that the Deputy Minister's observations on the subject will provide us ample food for thought for the two days of our deliberations here.

I should like to congratulate UNCTAD on its research work on the subject of East Asian development and the policy lessons that can be drawn for other developing countries. The substantial number of background papers prepared for this Conference, in fact, testifies to the long hours of painstaking research put in by the UNCTAD research team. I would like to take this opportunity to thank UNCTAD for inviting ISIS to be a part, albeit a small one, of this effort through our role as the local host of this Conference.

Once again, I bid you a warm welcome and a successful Conference. Thank you. ■

Keynote address

THE EAST ASIAN DEVELOPMENT MODEL: ITS RELEVANCE IN A CHANGING WORLD ECONOMY

Y.B. Kerk Choo Ting[*]

Ladies and gentlemen,

Welcome to all participants of this Conference. Let me take this opportunity to thank the organizers for inviting me to deliver the keynote address.

The world today is witnessing unprecedented political and economic changes. East Asia has been the centre of these changes. Japan, China, the newly industrializing economies (NIEs) (Hong Kong, Singapore, the Republic of Korea and Taiwan Province of China) and ASEAN have achieved unprecedented levels of real economic growth in the past two decades, averaging 7.3 per cent per annum (China, NIEs and ASEAN). Over the same period, the world economy grew by only 3 per cent per annum. This outstanding performance has earned East Asia the reputation to be regarded as the world's "growth centre".

Since the mid-1980s, more than half of the increase in world production of goods and services has occurred in East Asia.

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[*] Deputy Minister of International Trade and Industry, Malaysia.

Between 1986 and 1991, growth in Japan's added annual output was equivalent to an economy the size of France. Internationally oriented growth became firmly entrenched in East Asia's most populous economies, China and Indonesia, and has commenced in Viet Nam. This dramatic growth, especially in the region's developing countries, continued undiminished in the early 1990s, despite deep and prolonged recession in the advanced industrial economies in Europe and the United States.

The countries of East Asia are at differing stages of economic development, and the region is characterized by enormous ethnic and religious diversity and a rich historical heritage that predate the Christian era. Such diversity, however, was not a stumbling block to intraregional trade and cultural interactions. Since ancient times, there has been lively interaction along sea and land routes within the region, and rich varied cultures still exist across national borders in the region. It is important to remain aware of this characteristics, which has enabled the East Asian economies to foster intraregional interaction and interdependence as a foundation for the development of the region.

Historically, Japan took the lead in economic transformation during the post-World War period. However, much of the basic ingredients for this transformation began much earlier during the Meiji Restoration era in the 19th century. Rapid, internationally oriented, economic growth was established in Japan and Hong Kong in the early 1950s. Taiwan Province of China, Singapore and the Republic of Korea followed suit in the 1960s, and then later on Malaysia, Thailand, China and Indonesia.

In most cases, economic development and high growth were attributed to strategic shifts in economic policies from agriculture or commodity-based economies to industrialization. Economic development occurs in tandem with political and social stability. Such periods of political and social stability provided a conducive environment for the implementation of long-term economic policies. This was evident in Japan during the post-World War period, in the Republic of Korea after the Korean War, Malaysia after 1969 and China during the post-Mao period. Thus, political and social stability in whatever context or form, be it in the democratic, communist, socialist or autocratic environment, was the catalyst for economic development in the region.

In addition, positioned on the front line of East-West confrontation, the East Asian economies have existed in an environment of "stability in the midst of tension", while benefiting from the support of the United States in the areas of security and economic development during the cold war period.

The end of the cold war is reshaping the international environment of the East Asian market economies as decisively as the cold war itself shaped international economic relations in the 1950s and 1960s. The end of the cold war has brought new opportunities to China, as the greater security on its long land borders allows more confident and complete application of national energies to the tasks of economic reform and development.

The effects of the end of the cold war on US support for the post-war framework of open multilateral trade are at once more complex and more important to economic development in East Asia and the Pacific. This is the new environment of US commitment to its domestic, political and economic issues in relation to open and multilateral trade. It is the environment of the damaging tension in Japanese-American trade relations. And it is part of the complex environment of Sino-American economic relations, which is then overlaid by divergent perspectives on human rights, and concerns about the implications of Chinese arms sales on the stability of relations among countries in the new strategic order that is emerging in the aftermath of the cold war.

East Asian economic development has not been achieved by any specifically defined model. Rapid economic growth in East Asia has been achieved through pragmatic trade policies in the midst of a relatively stable political environment. Until recently, any assessment of the sustainability of East Asian growth would have been made with a strong qualification about its vulnerability to weaknesses in the international trading system. However, this is no longer the case as the large majority of East Asian export growth has been brought about by intraregional expansion of markets in East Asia itself. One reason for this increased intra-East Asia trade is that there has been no economically important trade-expanding discrimination in East Asia. In fact, the East Asia economies have undertaken more trade and economic liberalization in the last two decades than any other group of countries. This liberalization and rapid economic growth is in no small measure due to the active participation of governments in East Asia. Having achieved independence under the guidance of strong leaders, the peoples of the East Asian economies have worked to achieve national progress through industrial development. The progress of industrialization in the East Asian economies is a reflection of the excellent receptiveness of their peoples to new ideas and knowledge. It is also the result of the successful blending of aid, direct investment and industry relocation from the developed countries.

Two economic factors that have contributed to development in East Asia are direct investment and trade. Direct investment in the NIEs and ASEAN registered double-digit growth in 1988; Japan and the United States were the main sources of investment in East Asia. The NIEs became new sources of investment and eventually overtook Japan and the United States, and reached 48.5 per cent share of total investment in the region between 1988 and 1992.

According to the *World Investment Report 1995*, Asia and the Pacific, particularly the East and South East Asian subregion, have emerged as the most dynamic region worldwide, in terms of economic performance, with large and growing markets and profitable investment opportunities in manufacturing and services. This has led to an increase in the region's share in FDI stock, which rose from 7 per cent to 12 per cent of worldwide stock during 1980-1993 and from 30 per cent to 49 per cent of the developing countries' FDI stock during the same period. In 1993, the East Asia region FDI stock was US$ 101,339 million. In terms of investment inflows, an estimated US$ 58,493 million flowed into this region in 1994. It is this upsurge of investment within the region, led by the NIEs, that has promoted interdependence as a key factor in the economic development of East Asia.

In 1992, ASEAN was the leading host region for FDI inflows with US$ 17,824 million, followed by China US$ 11,156 million and the NIEs (excluding Singapore) US$ 3,480 million. In 1994, it is estimated that China alone would draw US$ 33,800 million, with ASEAN receiving FDI inflows of US$ 19,545 million. China has now emerged as the region's frontier for investment.

Besides direct investment, trade is the other key factor which has propelled the East Asian region to the forefront of economic development. Between 1983 and 1993, at a time when total world exports increased only 2.2 times, the combined exports of the NIEs, ASEAN (including Viet Nam) and China increased 3.7 times from US$ 162.2 billion to US$ 213.9 billion. By the early 1990s, the value of trade among these economies was greater than that the value of trade between East Asia and the United States.

Total intra-East Asian trade (among selected economies) increased from US$ 560.9 billion in 1990 to US$ 895.0 billion in 1994, an increase of 59.6 per cent. Exports during the same period increased from US$ 279.3 billion to US$ 444.6 billion (59.1 per cent) and imports from US$ 281.6 billion to US$ 450.4 billion (59.9 per cent).

As I said before, we cannot attribute the success of East Asian economic growth to any particular model, but we can identify certain factors that have enabled Asia to become the world's "growth centre". The first factor is the confidence to undertake ventures, which comes from the success of the region's peoples in achieving social integration, economic construction and internationalization. This is pre-empted by the shifts of economic policies from commodity-based to industrial economies, and implementation of these policies in a relatively long period of social and political harmony.

The second factor is the role of direct investment and trade as catalysts for the emergence and expansion of borderless economic interaction at a localized level, accompanied by the development of horizontal divisions of labour based on product or process, and the expansion of complementing networks of interdependence within the region. Evidence of these changes includes the circulation of Hong Kong dollars in China's Shenzhen and Guangdong Province, and the role of the Thai baht in Indochina.

A third factor that must be taken into account is the continuing expansion of the scope of economic development in East Asia through successive waves of industrialization in the Republic of Korea, Taiwan Province of China, Singapore, Malaysia, Thailand, Indonesia, and now China and the Indochinese countries, using industrialization in neighbouring developed economies as their model.

What are the prospects for the East Asian economies in the 21st century? While East Asia may face a number of obstacles to growth on its future economic development path, it should be able to maintain its present momentum at least until the early 21st century. The NIEs and ASEAN should be able to maintain an average growth rate of 6.6 per cent per annum, while China is expected to achieve growth averaging around 8.2 per cent.

Growth on this scale will boost the real GDP of the 11 East Asian economies (NIEs, ASEAN, China, Viet Nam and Japan) to the size of the US economy, which is projected to reach US$ 7 trillion in the year 2001.

The emergence of East Asia as one of the three major centres of production and trade, alongside Western Europe and North America, has created an impact on the international trading system. East Asia has had to adjust to the current situation associated with rapid growth, coming as they did at a time of slower growth and higher unemployment in the North Atlantic economies. By the 1980s, the post-war rules were recognized as being inadequate, and requiring development for the management of new forms of trade, including services and the related matters of intellectual property rights. The Uruguay Round, supported by the United States and Japan, extended the rules to new areas.

East Asia's internationally oriented growth, and comparative success through the 1980s and early 1990s, increased tendencies towards discriminatory regionalism in Europe and North America. It was this factor that accelerated the move towards European economic integration, and, alongside frustration with slow progress in the Uruguay Round, towards the formation of the North American Free Trade Area (NAFTA). By the early 1990s, these and other moves towards discriminatory regionalism constituted threats to the liberal multilateral trading system, as important as those that the Uruguay Round has been established to remove.

Continued growth in East Asia is likely to be the primary influence on world trade and economic growth in the next quarter of a century and beyond, just as it has in the past. While East Asian developing economies have shown in recent years that they can grow strongly as a consequence of the recession in Japan as well as in other advanced industrial economies, there is nevertheless anxiety about the sustainability of growth on the pattern of the recent past. It cannot be denied that the East Asian developing economies have benefited from the continued industrial transformation and expansion of direct foreign investment. The opening up of the market in China has contributed to the expansion in the NIEs and other ASEAN economies.

The East Asian growth model of the past two decades was based on the openness of the world economy to absorb the massive output of exports through industrialization. The industrialization process was fuelled by the huge inflows of FDI from the triad members (Japan, the United States and Europe).

The future of East Asian economic development has become more complex as these economies progress from industrial development to post-industrial development and beyond. Over-dependence on FDI without improving its own technological capabilities would itself cause strains in further economic growth. Therefore, economic growth in the region depends on how these nations approach such challenges in the absence for at least another generation of political and social upheavals. This includes their efforts to upgrade their intrinsic technological capabilities through education and training, research and development and rapid commercialization of R&D efforts. The advent of high technology and the cost of developing and acquiring such technologies will determine whether East Asian economies have the strength to sustain their own economic development, or just be the offshore manufacturers of those that possess such technologies.

With these thoughts in mind, I would like to declare open the Conference on East Asian Development: Lessons for a New Global Environment. Thank you. ■

Session 1

REGIONAL AND NATIONAL DIMENSIONS OF EAST ASIAN DEVELOPMENT

Chairperson:	*J.-H. Jeong* Senior Research Fellow, Korean Economic Research Institute, Seoul, Republic of Korea
Introductory statement:	*Robert Rowthorn* Professor of Economics, Faculty of Economics and Politics, University of Cambridge, United Kingdom
Panellist:	*Gorota Kume* Director General, Research Institute for International Investment and Development; Deputy Head, EXIM Bank, Tokyo, Japan
Panellist:	*V.R. Panchamukhi* Director, Research and Information System for Non-aligned and Other Developing Countries, New Delhi, India
Panellist:	*F.-C. Lo** Deputy Director, United Nations University, Institute of Advanced Studies, Tokyo, Japan

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* Written statement unavailable.

Introductory statement

*Robert Rowthorn**

My presentation is concerned with the economic development of East Asia. The main issues considered are: the role of Japan in this process and its relationship with the rest of East Asia, the evolving patterns of economic integration within the region, and the economic linkages between this region and rest of the world, in particular Europe and North America.

I. The "flying geese" paradigm of FDI, economic development and shifts in competitiveness

It is true that economic development in East Asia has proceeded in waves, with Japan first, then the first-tier NIEs (Hong Kong, Singapore, the Republic of Korea and Taiwan Province of China), then the ASEAN-4 (Indonesia, Malaysia, Philippines and Thailand) and, most recently, China and Viet Nam. It is also true that as the East Asian countries have developed their productive and trade structures have undergone the kind of transformations implied by the "flying geese" paradigm. The locus of employment has shifted from agriculture and resource extraction towards manufacturing, and in the most advanced economies is undergoing a new shift towards services. Within the manufacturing sector, the initial stage of development has been focused on labour-intensive activities, such as clothing, which at a later stage are supplanted by capital-intensive or skill-intensive types of production. This progression is mirrored in foreign trade. In East Asia, as elsewhere, development is initially accompanied by an explosion of labour-intensive exports, but these eventually become unprofitable under the combined impact of rising wages at home and competition from the next wave of industrializing economies, where labour is still very cheap. To stay ahead, the countries which have developed first have been forced to move up the trade hierarchy and export more sophisticated products where they now have a comparative advantage.

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Thus, in the course of development, the countries of East Asia have gone through, or are still going through, the stages predicted by the flying geese paradigm. There is also a definite hierarchy of countries, with Japan in the economic lead, followed by the said tier NIEs, then the ASEAN-4 and finally China and Viet Nam. This is incontrovertible. However, there is more at stake in the flying geese paradigm than pure description. The significance of the paradigm lies in its analysis of the linkages between the different countries in the hierarchy, of the process by which development is transmitted from one country to another, and of the stability of the hierarchy itself. It is here that the paradigm is unsatisfactory, at least in the form presented by Ozawa (1995). It exaggerates both the role of Japan as the leader of East Asian development and the role of transnational corporations (TNCs) as the agents of change. It also paints an overly harmonious picture in which East Asian development is presented almost in entirely cooperative terms, while the conflictual and competitive aspects of this process are virtually ignored.

II. The role of Japan

Japan's greatest impact on East Asia has been as a role model for aspiring countries in the region. It has shown the spectacular results that can be achieved, under appropriate political conditions, through the right combination of state intervention and business enterprise. Many institutions and policies have been copied from Japan and modified to suit local conditions.

In other dimensions the impact of Japan has been varied. Japanese exports to East Asia are booming and it is now a major supplier of manufactured goods to the region. Trade flows in the opposite direction are relatively small, and until recently the Japanese market was of minor importance for most Asian exporters. Foreign direct investment (FDI) by Japanese firms is growing rapidly, but this is a comparatively new phenomenon and the amounts involved are not very large in relation to the East Asian development effort as a whole, although they are important in some individual countries or industries. Japan is a major supplier of knowledge to the region through the medium of licensing and other forms of technology transfer, although both Europe and North America have also been important in this field.

A. Trade

Let us consider first the issue of trade. The situation is as follows. Japan has a very large and growing surplus in machinery and transport equipment with the first-tier NIEs, the second-tier NIEs (ASEAN-4) and China taken separately. With the exception of clothing and footwear, where there is an increasing deficit, Japan has a surplus in most other manufacturing items. For many items the Japanese trade surplus with East Asia has increased, despite the fact that exports to the region have been rising more slowly than imports. This discrepancy is explained by the fact that the volume of Asian goods purchased by Japan was initially very small when the period of rapid growth began. This is very striking in the case of the second-tier NIEs (ASEAN-4).

Despite the rapid growth of imports, the Japanese market is still of secondary importance for most East Asian countries and most products. However, there are certain exceptions. Japan accounts for about one-half of all external exports of food, raw materials and fuel from East Asia (i.e. excluding trade between countries within the region). The importance of Japan is much less in the case of manufactured goods. Around 15 per cent of external exports of manufactures from East Asia currently go to Japan, and the vast majority still go to other developed market economies in Europe and North America. In recent years, there has been an upsurge in Japanese imports of electronic goods from East Asia, such as telecommunications and sound equipment from Malaysia, electronic micro-circuits from the Republic of Korea, and automatic data processing equipment from Singapore and Taiwan Province of China. This development has received considerable attention, but in fact the scale of such trade is still quite small. In 1993 only 10.9 per cent of all external exports of machinery and transport equipment from East Asia went to Japan. In more detail, the percentages were as follows: office machinery 7.0, electrical goods 13.3, road vehicles and parts 6.8, other machinery 11.7.[1] Thus, despite the proximity of Japan to East Asia, and despite the recent growth of imports from the region, Japan is still much less important as a market for Asian manufactures than Europe or North America. This is partly explained by the relative size of Japan. Per head of population, Japan imports roughly the same amount of manufactured goods from East Asia as does the United States or the average European country.

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[1] Data in this paragraph are from the UNCTAD database. External exports of non-Japanese East Asia exclude trade between the countries of this region.

However, because of their much greater populations, the total imports of the United States and European Union from East Asia are much greater than those of Japan.

The flying geese paradigm implies that, as the lead goose, Japan has been a leading market for labour-intensive exports from East Asian countries during the initial stages of their development. This is incorrect. In most cases, the share of labour-intensive exports from a number of East Asian economies going to Japan has been tiny, often less than 3 per cent. The major exception are clothing exports from the Republic of Korea, of which Japan took between 20 per cent and 50 per cent in 1990, depending on the item concerned. It is interesting to note that the share of clothing exports going to Japan was quite low in the 1970s, when the Republic of Korea was in an earlier stage of development. Only during the 1980s, when the latter's economy was already rather developed, did clothing exports to Japan really take off. It is also striking what a small share of labour-intensive exports from the ASEAN-4 go to Japan. The figure is rarely more than 10 per cent and sometimes much less.

Given the close proximity of Japan to East Asia, we should expect to see a much greater volume of imports than is actually the case. To throw some light on this question, let us look into the trading patterns of Mexico and Spain, which are both countries with a large, more advanced trading partner on their doorstep. Over the past decade the United States has absorbed well over 80 per cent of all manufactured exports from Mexico. In the case of Spain, the proportion of manufactured exports going to the European Union has been increasing and is now almost 70 per cent. These figures are many times greater than the corresponding figure for East Asian exports to Japan. This brings out a significant asymmetry in Asian trading relations which is absent in the case of Europe and North America. Within the latter economic zones, trade is roughly balanced so that imports and exports between countries are similar in magnitude. This is not the case in Asia. Japan is a massive exporter to East Asia, providing around 45 per cent of all manufactured goods supplied from outside this region. Moreover, the region has become increasingly important as a market for Japan and now takes around a third of all its exports. Since Japan buys comparatively little in return, the result has been the emergence of an unusual trading pattern, with Japan enjoying a large trade surplus with East Asia and the latter region enjoying a large trade surplus with other industrial countries. Note that this is not an example of "triangular trade", since Japan does not use its surplus with East Asia to finance imports from the rest of the world. On the contrary, Japan is in surplus with both East Asia and the rest of the world simultaneously.

B. Direct investment

The accumulated value of Japanese FDI in East Asia has increased dramatically in recent years, while there have been major shifts in the direction of new flows. A decade ago, in 1985, almost half of all Japanese FDIs in East Asia was located in Indonesia, mostly in natural resource industries and labour-intensive manufacturing.[2] Singapore was also a significant location, with Japanese FDIs worth around US$ 2 billion, mostly in the manufacturing sector. FDIs in Hong Kong were somewhat larger, but it is not clear exactly what such investments comprised, since they were located almost entirely in "other non-manufacturing", which excludes finance and insurance and retail estate. Apart from these countries, Japanese FDIs in East Asia were modest. One striking fact about the situation in 1985 is the small value of manufacturing investments. In only Singapore and Indonesia were Japanese FDIs in the manufacturing sector worth more than US$ 1 billion. Such statistics understate somewhat the economic importance of Japanese firms, since at that time many host countries insisted on joint ventures as a condition for accepting FDI. In recent years countries have been willing to allow wholly-owned subsidiaries as the climate in East Asia has become more favourable to outside investment.[3]

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[2] The information in this paragraph is from MITI (1994).

During the past decade, the stock of Japanese FDI in East Asia has quadrupled. In manufacturing, new investment during the 1980s went to the first-tier NIEs and the ASEAN-4, but in the 1990s attention has switched to China. This recent switch is mainly due to the rapid growth of China and the desire of Japanese firms to get a foothold in such a potentially vast market. The expansion of FDI in East Asia reflects the interest of Japanese firms in the region and their hopes and fears concerning its future. Some may interpret this investment as confirmation of the flying geese paradigm, whereby Japan plays the role of leader pulling along the rest of Asia through the medium of FDI. Such an interpretation would be misleading for two reasons. Firstly, there are several important countries in East Asia which have developed rapidly without relying heavily on FDI from any source. Secondly, Japan is by no means the only major investor in the region.

The role of FDI in East Asia varies widely between countries and through time. Foreign affiliates accounted for 40-50 per cent of manufacturing sales in Singapore and the ASEAN-4 in the late 1980s, whereas for the Republic of Korea and Hong Kong the figures were 21.5 per cent and 17.3 per cent respectively. No figure is given for Taiwan Province of China, but the situation is probably similar to that of Hong Kong. These statistics should be treated with caution because they refer to affiliates, many of which are joint ventures and may include a large domestic contribution. In 1986, foreign affiliates employed 11.4 per cent of all manufacturing workers in Taiwan Province of China, but when the numbers are weighted by equity holdings, the foreign share falls to 6.5 per cent. This illustrates how crude data on affiliates may exaggerate the foreign stake. On the other hand, looking only at broad aggregates may lead to the opposite bias. In the Republic of Korea, for example, foreign affiliates accounted for a quarter of all manufactured exports, which is many times greater than their small shares of GDP or gross capital formation, which are the figures often cited to establish the minor importance of FDI in the Republic of Korea. In the key electrical and electronics sector, the share of foreign affiliates was between 65 and 73 per cent (Lee and Ramstetter, 1991). Thus, although development in the Republic of Korea and Taiwan Province of China relied mainly on domestic firms, a major role was, and still is, played by FDI in certain sectors of the economy.

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[3] For an analysis of FDI in the electric appliance industry see Sunada *et al* (1993)

It is a matter of speculation how far the development of the Republic of Korea and Taiwan Province of China would have been hindered if FDI had never occurred. In its absence, they would have been forced to acquire technology and management skills in other ways. The experience of the Republic of Korea in shipbuilding and steel shows how this can be done. With the help of technical and managerial assistance from foreign companies, such as A&P Appledore and Scotlithgow from Britain and, above all, Kawasaki Shipbuilding and Nippon Steel from Japan, in the Republic of Korea world-class industries were created within the space of a decade (Amsden, 1989). If this type of assistance had not been forthcoming, the task of catching-up would have been far more difficult and the Republic of Korea would have had to rely on reverse engineering, reading the technical journals and similar inefficient ways of acquiring knowledge. This would have seriously damaged the development of the Republic of Korea and similar countries. To develop major new industries without some form of help from companies in the leading countries is a formidable and sometimes impossible task. Even the Soviet Union in the 1930s was aided by capitalist firms from the West who provided designs, advice, training and equipment for Stalin's industrialization drive. Their motivation was not altruism, of course, but profit.

It is widely thought that economic development in East Asia is becoming more dependent on FDI. If we ignore Singapore, the East Asian countries can be classified into the following groups according to their level of economic development: Japan, the first-tier NIEs (Hong Kong and the Republic of Korea), and second-tier NIEs (Malaysia, Philippines and Thailand). For these groups, the share of foreign affiliates in manufacturing sales in the late 1980s was in the range 2.2 per cent, 17.3-21.5 per cent and 40.5-48.6 per cent respectively (Wilkins, 1995). Thus, the role of FDI does seem to be greater in the more recent East Asian countries to industrialize. Even so, apart from Malaysia, FDI still accounts for a relatively small share of total investment among the later countries to industrialize.

Japanese FDI in Asia is heavily skewed towards manufacturing, which accounts for about 80 per cent of all employment by Japanese firms in the region. This is much higher than in Europe or the USA, where manufacturing accounts for around 40 to 60 per cent, respectively, of employment by Japanese firms. In most Asian countries, the share of Japanese firms in national manufacturing employment is very small. Important exceptions are Malaysia and Thailand, where the share is quite substantial. In particular industries the figures are, of course, much higher. Japanese affiliates in the electrical and electronics industry are the major producers in this industry in Malaysia and Thailand, and they are also important in Taiwan Province of China and the Republic of Korea.

Although Japanese FDI in the ASEAN-4 countries has been growing rapidly, investment from other countries has been growing even more rapidly. As a result, the Japanese share in accumulated FDI is falling and is now in the range 15-38 per cent, depending on the host concerned (MITI, 1994). Although Japan is the largest single investor, Europe and the USA are both important. The most striking development is the mushrooming of direct investment from Hong Kong, the Republic of Korea, Singapore and Taiwan Province of China. Between them, these first-tier NIEs now have more direct investments in the ASEAN-4 than Japan. Indeed, Taiwan Province of China alone has more direct investment in Malaysia than Japan. This explosion of investment by the first-tier NIEs is in line with the flying geese paradigm.

Japan plays only the secondary role as the provider of FDI for China. Despite its rapid growth in recent years, the value of Japanese FDI in China has been very small. As a direct investor, Japan is of similar importance to the USA, and its activities are dwarfed by those of overseas Chinese located in such places as Hong Kong, Macau and Taiwan Province of China. Much of the apparent FDI by overseas Chinese is merely a recycling of funds which originate in China itself. Domestic firms with money to invest team up with overseas Chinese, who invest the money back in China, where it receives the privileges and protections accorded to foreign investors. Harrold and Lall (1993) estimate that 25 per cent of all FDI inflows in 1992 were of this phantom variety. Wherever the funds and initiative for investment by overseas Chinese ultimately originate, the vast scale of it shows that Japanese firms are still minor players on the Chinese stage.

III. East Asia

We have already seen how the first-tier NIEs have emerged as major investors in the less developed countries of East Asia. They have also become important trading partners for their less developed neighbours. Like Japan, they supply manufactured goods on a large scale to these countries, but unlike Japan they also purchase manufactures on a large scale. In 1993, the second-tier NIEs (ASEAN-4) exported manufactured goods worth US$ 21.8 billion to the first-tier NIEs and less than US$ 10 billion to Japan. According to the UN *International Statistics Yearbooks*, Chinese exports of manufactures to these areas were US$ 23.7 billion and US$ 10.2 billion respectively. Thus, the first-tier NIEs were roughly twice as important as Japan as outlets for the manufactured exports of their less developed neighbours. It is interesting to note that the same is also true for trade within the first-tier NIEs, who export far more to each other than they do to Japan.

The evidence suggests that there is a rapid process of integration taking place within the smaller countries of East Asia, and even China is becoming involved in this to some extent. Trade between the countries of East Asia (excluding Japan) has been rising much faster than trade with the outside world, and around one-third of all the exports and imports of these countries is now within the region. Although Japan has a huge trade surplus with East Asia, the average country in this region now imports more manufactured goods from other East Asian countries than it does from Japan. Japan remains the dominant supplier of road vehicles and other machinery, but it has been overtaken in chemicals, electrical equipment and office machinery, where imports from the rest of East Asia now exceed those from Japan. The above trends in FDI and trade provide mixed support for the flying geese paradigm. The role of Japan as leader is open to question, but among the remaining countries it does seem to be the case that industrialization is being transmitted from one wave of developing countries to the next wave by the mechanisms postulated in this paradigm.

Two factors limiting the degree of integration in the East are the position of Japan and the huge size of China. To integrate Japan fully into the East Asian economy would require a substantial change in the functioning of the Japanese economy. At present, Japan is a huge provider of exports and FDI to East Asia, but there is very little flow in the opposite direction. Even countries which are quite advanced export little to Japan and invest even less. Exports and FDI from East Asia into Japan are growing, but there is a long way to go to redress the imbalance in Japan's economic relationship with the region. Another obstacle to a fully integrated economy in East Asia is the huge size of China. Any integration between China and the rest of East Asia is bound to be asymmetrical. Because of its gigantic population, trade will never be as important for China as it is for the smaller countries around it. For better or worse, the bulk of Chinese output will always be sold at home, just as the bulk of West European output is sold at home. Moreover, as per capita incomes rise in China and the country's economic weight in the region increases, the surrounding countries may fear domination by their giant neighbour, which may put a brake on the pace of economic integration.

An important feature of East Asian trade is the region's surplus in manufacturing trade with the developed market economies of Europe and America. In the case of China and the ASEAN-4, this surplus reflects their rising exports of clothing and other labour-intensive items, which now exceed their imports of more sophisticated items such as chemicals, machinery and transport equipment. The picture is more complex in the case of the first-tier NIEs. These countries still have a large trade surplus with Europe and North America in clothing and other labour-intensive products, but this surplus is diminishing as they develop and shift to more sophisticated products. There has been a spectacular growth in exports of machinery and transport equipment from the first-tier NIEs over the past decade, and these countries now have a large surplus in this type of trade with Europe and North America.

It is interesting to speculate how trade between East Asia and the developed countries of Europe and North America will evolve in the future. The poorer countries of East Asia will continue to export labour-intensive goods, such as clothing and toys, on a large scale. However, they will also export some more sophisticated products as they acquire the technology and gain a competitive advantage from the fact that they still have relatively low wages. This will be especially true of China. The wages of unskilled labour in the industrializing coastal region of China are likely to be kept down by inward migration from the rest of the country. This will make labour-intensive manufactures and non-traded services very cheap and hold down the cost of living in the coastal region. This in turn will allow skilled workers to enjoy a high standard of living with earnings that are low by international standards. Firms which are able to produce sophisticated manufactures efficiently will thereby gain a competitive advantage in international trade, since they will combine modern production methods with cheap labour. This has not happened on a large scale so far in East Asia, since countries which have acquired modern technology have simultaneously experienced rapid earnings growth because they have run short of labour. If the coastal region of China manages to combine modern technology with cheap labour, through the mechanism described, it will become a formidable competitor in certain types of advanced products. There will, of course, be many areas where the advanced countries still hold a competitive advantage, but Chinese exports will not be simply confined to products of the unskilled labour variety. The same may also be true of other poor, large countries such as India and Indonesia. Their future combination of low wages and high levels of competence in certain knowledge-intensive activities may make them super-competitors in such activities.

IV. Regionalization

Let us explore further the issue of economic relations between Japan and the rest of East Asia on the one hand, and the advanced economies of Europe and North America on the other. There is reason to believe that the advanced economies are developing a regional bloc structure in which manufacturing trade within blocs is intense, but there is only a limited trade between blocs.[4] FDI plays an important part in this process. Within blocs, FDI and trade are to some extent complementary, since FDI often serves to extend the intra-bloc division of labour and thereby encourage trade between different parts of the bloc. Between blocs, FDI is more likely to be a substitute for trade, since transport and allied costs (cultural distance, etc.) are relatively high and the regional market is large enough to make local production economical. Another factor is protection. Although trade barriers are supposed to be lower following the Uruguay Round, the major regional trade blocs, such as NAFTA and the EU, will still discriminate against third parties, and there will still be an incentive for outside firms to jump protective barriers by producing locally. Moreover, there is always the risk that economic and political forces may lead to a revival of protectionist sentiment in these blocs.

The trend towards regionalization has been clearly visible in Europe and North America. Within each regional bloc there has been a massive growth in manufacturing investment and trade, and many large firms now operate an extensive intra-bloc division of labour. However, manufacturing trade between Europe and North America is modest in scale, and many large firms produce in both regions rather than export. In 1992, manufactured exports from Western Europe were only 1.23 per cent of European GDP and around 3 per cent of US expenditure on manufactures (Rowthorn, 1995). US manufactured exports in the other direction were only 1.62 per cent of American GDP and around 2 per cent of European expenditure on manufactures. In the case of Japan the situation is at present rather different. The country still exports a great deal to Europe and North America, although its imports of manufactured goods are small. One response to this imbalance would be for the country to raise its imports from Europe and America dramatically. A more likely path is for Japanese firms to invest more in Europe and America, and replace exports to these regions by local production. This has already happened in some areas, such as motor cars, but it is likely to happen on an increasing scale in the future. One factor pushing Japanese firms in this direction is the high yen, another is protectionist pressure from governments in the EU and North America.

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[4] The issues raised in this paragraph are discussed in Hymer and Rowthorn (1970), Rowthorn (1971, 1995). See also Petri (1994).

At the present time the first-tier NIEs still enjoy a large trade surplus with Europe and North America in labour-intensive products. However, this surplus is likely to fall away rapidly as wages in these countries rise. The first-tier NIEs are now beginning to export more sophisticated products to Europe and North America. However, the long-run evolution of such exports may be subject to the same forces which have limited trade between the European and North American regional blocs and are now operating on Japanese firms. Big firms from the first-tier NIEs, such as Daewoo and Samsung, are going transnational and beginning to invest on a large scale in Europe and North America. At present, some of this investment may actually stimulate exports of intermediate and capital goods from their home countries. A more important effect in the future is likely to be a loss of sophisticated exports, as production of such items is transferred from East Asia to local plants within the distant regional blocs. Economic and political factors may lead many East Asian firms to follow this route and rely on FDI as the primary method of serving their markets in Europe and North America. Thus, the present dependence of the first-tier NIEs on large scale exports to these areas may be a transitory phase. The first-tier NIEs are now reducing their exports of labour-intensive goods to Europe and North America and switching to more sophisticated exports. These more sophisticated exports may, in turn, be replaced by FDI as

East Asian firms decide to produce locally in Europe and North America. If this happens on a substantial scale, the present dependence of the first-tier NIEs on exports to these areas will greatly diminish.

Prediction is hazardous, but my view of the likely evolution of East Asia is as follows. Economic ties within the region will become ever closer under the combined impact of trade and investment. Large-scale exports of labour-intensive products from the poorer countries of East Asia to Europe and North America will continue and may even increase if protection in these areas is relaxed, which is supposed to happen under the Uruguay Round. There will also be some growth in exports of more sophisticated manufactures to Europe and North America. However, such exports will be limited by both economic and political factors. To penetrate the markets of Europe and North America, the larger firms in East Asia, along with their Japanese counterparts, will rely increasingly on FDI, and this will limit the volume of sophisticated exports. The result will be a consolidation of the existing bloc structure, whereby a closer-knit regional bloc develops in the East to take its place alongside the European and North American blocs. Two-way trade in sophisticated products between these different blocs will be modest, and much of the interchange between East Asia and the other blocs will be of the North-South variety, with the poorer countries of East Asia exporting labour-intensive products to Europe and America in return for knowledge-intensive goods and services.

Let us consider the likely evolution of exports and outward FDI towards Europe and North America from a typical East Asian country. In the initial phase of development, the East Asian country exports labour-intensive products to these areas. As the country industrializes, wages rise, it acquires more sophisticated technology, and the composition of exports shifts away from labour-intensive products towards more sophisticated, knowledge-intensive products. However, this is only a phase. As knowledge-intensive exports to Europe and North America grow, the exporting firms gradually consolidate their position in these distant markets. As they acquire sufficient knowledge of these markets and their sales grow, local production in North America and Europe becomes an increasingly attractive proposition. At a certain point the Asian firms go transnational. Instead of exporting from their home base, they invest in Europe and North America and produce locally, so that knowledge-intensive exports to these areas stagnate or even decline. This third phase is not seriously considered in the wild-geese paradigm, which is primarily concerned with relations between countries at different levels of development. It has little to say about relations between advanced countries.

V. Cooperation, competition and conflict

As the Japanese economy has developed, its economic relations with the rest of East Asia have changed. So too has the wild geese paradigm. This paradigm was originally formulated by Akamatsu (1932), when Japan was still a comparatively poor country, seeking to catch up with the more advanced countries of Europe and America.[5] His version of the paradigm reflected Japan's own experience and the country's interests at the time he was writing. Trade was seen as the major vehicle of technology transfer, while TNCs played only a minor role. Moreover, the relationship between follower and leader had a said dimension. Exports from the leading country to its follower would drive local producers out of business since imports would be either much cheaper or of a modern type that local firms could not match.

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[5] With the exception of Akamatsu (1962), few of his writings are available in English. For a good exposition of Akamatsu's views see Korhonen (1994).

The immediate result would be impoverishment for traditional producers in the follower country. In the course of time, however, the situation would eventually be reversed. Consumers in the follower country would acquire a taste for modern goods and the local market for such goods would expand. When this market was large enough, local firms would counterattack. With the help of government support and protection, they would discover ways to produce modern goods themselves and drive out imports. This is not the harmonious "recycling of comparative advantage" that more recent exponents of the flying geese paradigm talk about, but a genuine conflict in which local entrepreneurs are engaged in a "death struggle" against imports, and "pour their hearts' blood" into copying foreign goods and inventing new ones so as to win the upper hand over imports (Akamatsu, 1956). As the follower country masters the new technology, the result may be impoverishment for those who work in this industry in the leading country, and the wheel will thus turn full circle.

More recent versions of the flying geese paradigm have altered this picture in two ways. Kojima (1973, 1985) stresses the role of direct investment as a means for transferring technology to follower countries. He also presents a harmonious vision in which TNCs and the governments of the two countries collaborate in their mutual interest with little or no conflict. In industries where the leader is losing comparative advantage, the TNCs relocate production to the low-wage follower country, often with the help of both governments. This creates a space in the leading country, which can be filled by more advanced industries or product lines, thereby raising the living standards and providing employment for those displaced by the migration of older activities to the follower countries. This is essentially the picture that Ozawa (1995) and the UN *World Investment Report 1995* present when they talk of TNCs "recycling comparative advantage".

The modification of the flying geese paradigm to allow for the activities of TNCs is an obvious advance given their great importance in the modern world. The role of TNCs may be exaggerated in recent versions of the paradigm, but to ignore their role would be absurd. It is also the case that the transfer of technology, via TNCs and otherwise, has a cooperative dimension. However, it may also have a said dimension which is ignored or played down in current versions of the flying geese paradigm.

Three types of conflict may be distinguished: within countries, between countries, between countries and TNCs. These will frequently overlap and in many situations all types of conflict will be simultaneously present. In the writings of Akamatsu conflict between and within countries is clearly recognized. The initial penetration of imports into a follower country will benefit local consumers but impoverish producers. When local firms eventually develop and drive out imports, the follower country as a whole may benefit, while the leading country as a whole may suffer. These dangers are scarcely recognized in more recent versions of the flying geese paradigm, which ignore or seriously downplay the costs and difficulties of restructuring. Under present demand conditions many advanced economies are finding it difficult to replace the jobs lost through competition from labour-intensive imports from low-wage countries. They are also facing competition in more sophisticated products from developing or newly developed countries. The result is a growing fear of these countries and of their impact on the security and prosperity of workers in advanced economies.

Conflict between countries and TNCs can take many forms. In the present context, the most important concern the transfer of technology to host countries and the upgrading of productive activities. TNCs are profit-driven entities with a global perspective, whose long-term interests do not automatically coincide with those of the host country. The host country may wish to maximize the local content of TNC production, or to induce TNCs to locate high value-added activities within its borders and maximize spinoffs to the national economy by encouraging local firms to enter the industry. It may also wish to lock TNCs into the national economy and induce them to upgrade their technology in line with the changing needs of its economy as it develops. Such objectives may conflict with the natural desire of TNCs to safeguard their technological advantages and maximize their flexibility to relocate production in line with their shifting global priorities. TNCs can be a powerful engine for "recycling comparative advantage", but the extent and terms of this recycling are variable, and the more leverage a host country can exert over TNCs, the better deal it will get. This obvious fact is largely ignored in modern versions of the flying geese paradigm, which focus almost exclusively on the positive measures, such as educational and infrastructural investment, that host countries can take to attract and benefit from FDI. This leads to a neglect of the possible impact of the Uruguay Round on developing countries. There is considerable doubt surrounding what was agreed at the Uruguay Round since many of the wordings are rather unspecific, but it is conceivable that these agreements will be interpreted in a highly restrictive fashion, so that many of the trade-related measures traditionally used by East Asian countries in their dealings with TNCs will be outlawed. If this is the case, the bargaining power of host countries will be reduced and the role of TNCs as "recyclers of comparative advantage" may decline accordingly.

Conclusions

The main conclusions of this paper are as follows. In accordance with the flying geese paradigm, a rapid process of economic integration is now taking place in East Asia as more countries industrialize and a hierarchical pattern of FDI and trade emerges between them. Japan has played a major role as a model for other countries in East Asia to emulate, but until recently its direct economic impact on the region was limited by the fact that Japan itself was still quite a poor country. As the Japanese economy has matured, it has run down some of its more labour-intensive activities and these have been taken over, or are being taken over, by other countries in the region. This process has been aided by FDI from Japanese firms who see the developing countries of Asia as an export platform for supplying third markets in Europe, America and elsewhere. Until a decade ago, Japan purchased few manufactured goods from Asia, and its imports consisted almost entirely of primary products and services. However, this situation is now changing rapidly as manufactured imports from Asia mushroom. At the same time, Japanese exports to third markets are facing increasing competition from the more advanced Asian countries, while Japanese firms are starting to invest in Europe and America instead of exporting. In the medium term, these trends are likely to undermine Japan's huge external trade surplus and cause serious structural problems internally. If this happens, Japan's role as benign leader of the flying geese will come under increasing strain and difficult problems of interregional cooperation will arise. ■

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Comments on East Asian development and Japan's relationship with East Asia

*Gorota Kume**

It is a pleasure for me to have the opportunity of discussing the deep and many-faceted subject of East Asian development experiences. In this session on regional dimensions, I would like first to express my views on the success of East Asian economies, then to describe the recent Japanese relationship with this region, and finally to touch upon the future of those relations.

I. Success of the East Asia economies

The economic success of East Asia - I will use here the term "East Asia" to denote countries and territories encompassing NIEs and ASEAN - is obvious in many aspects, particularly in view of the high growth of GNP per capita. This is in sharp contrast to the poor performances which Latin America and Africa recorded in the 1980s.

The 1993 World Bank study on the *East Asian Miracle* analyses the eight high-performing Asian economies, including Japan. Focusing on public policy, it derives the following commonalties: the high growth with equity has been enabled by high investment and saving rates, export promotion policies, investment in human capital, and good macroeconomic management. Although this conclusion is to the point, others advocate the need to elaborate the institutional aspects and to pay more attention to the roles of foreign capital. I share such views, and the background papers of this Conference must also deal with these points. Another weakness of the World Bank study is its coverage of only the period up to 1990; I will attempt to look at more recent years.

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One policy issue yet to be discussed is that of the effectiveness of industrial policy, the use of which has varied among countries, with selective interventions that have often created inefficient industries. However, if Asian policy makers want to increase the added-value of natural resources and upgrade the industrial structure, when and how should they promote heavy and chemical industries or high-technology-intensive industries? South East Asian countries which have not so far used industrial policy extensively are now recognizing the need for developing petrochemical, automobile and other import-substitution industries in adapting themselves to new, more competitive environments. Their policy choices are likely to be difficult, but they would also be market-friendly, in response to world-wide trends of deregulation and liberalization.

When discussing the recent success of East Asia, my memory returns to the mid-1980s, when I was involved in loan operations for Asia at the EXIM Bank. In 1985, half of the East Asian economies were suffering from zero or minus growth. Policy makers were complaining about chronic trade deficits and stagnant Japanese direct investment. All of a sudden, the Plaza Accord started to correct the strong US dollar, and the Japanese yen was sharply appreciated. Around that time, most East Asian Governments shifted to or reinforced export-oriented policies and promoted inward investment. Then Japanese exporting companies were faced with the erosion of international competitiveness owing to the continued appreciation of the yen, and most of them started to make massive direct investments worldwide, including in Asia. At the beginning of that period, the Republic of Korea and Taiwan Province of China benefited from this situation and subsequently also encountered the same problems and pursued behaviours similar to those of Japanese companies. Under the high growth of the Chinese and Asian markets as a whole, Hong Kong and other Asian countries also started direct investment at a rapid pace. Thus, the East Asian economies have entered into a virtuous cycle since the late 1980s, triggered by the drastic changes of Asian exchange rates and Japan's direct investment surge.

In view of these developments, we could emphasize that the agile and proactive policy responses, in line with liberalization and deregulation, which were combined with continuation of appropriate macroeconomic policies, have stimulated high and sustained growth of East Asia. During the decade since 1985, the structures of the East Asian economies have changed in many fronts. Major changes are common to most economies notwithstanding with country variations: (1) high GDP growth supported by increased investment rates, particularly in China and South East Asia; (2) increased openness (i.e. increased ratio of trade to GNP), except for the Republic of Korea and Taiwan Province of China; (3) increased inward investment, particularly in South East Asia and China. Taiwan Province of China became a net exporter of capital, the Republic of Korea a large portfolio investment recipient, and South East Asian countries remained big borrowers. In spite of these remarkable improvements, some countries, particularly South East Asian ones, still have persisting or expanding current deficits.

II. Japan's recent relations with East Asia

Close economic relations with Japan have apparently contributed to the economic success of this region. It is often observed that Japan has exported much to this region, and machinery and equipment supplied by Japan have led the expansion of East Asia's production capacity. Japan is perceived to import less from this region, in contrast with the United States. And financially Japan is considered to contribute substantial amounts of aid but relatively less investment in East Asia. This understanding was more or less true in the 1970s and 1980s, but recent developments persuade us to modify our perception.

First, East Asia has very recently become Japan's biggest trading partner, in both export and import, surpassing the United States. Japan's exports to East Asia amounted to US$ 187 billion in 1995, and its share as a destination of total exports increased by 18 points during the decade from 24.1 per cent in 1985 to 42.3 per cent in 1995. Japan's imports from East Asia totalled US$ 118 billion in 1995, with East Asian percentage share of overall imports increasing by 10 points during the decade from 25.5 per cent to 35.1 per cent in 1995.

The rapid increase of trade in machinery and equipment is remarkable, to the point that this item now accounts for about two-thirds of Japan's export and 20 per cent of import from East Asia. This change reflects the rapid increase of Japan's direct investment in the past 10 years. However, the pace of the increase in trade among East Asian trading partners is higher than that with Japan.

Second, Japan has also been the major source of finance for East Asia, in the form of ODA, other official finance (OOF) and private credit, as well as foreign direct investment (FDI). In 1990, Japan provided US$ 11 billion, which accounted for roughly more than one-third of the total net resource flows into the region. In 1994, Japan provided a similar amount, but its share in the total flows dropped sharply; the total net amount tripled to US$ 90 billion; while other Asian capital and sources played bigger roles. In the 1990s, FDI has become the biggest form of financial flows from the world and also from Japan. It should be noted here that Japan's manufacturing investment in Asia is continuing to grow after a small drop in early 1990s, although total investment in this region has varied considerably. Between 1995 and March 1996, Japan's manufacturing investment directed towards Asia seems to have reached to US$ 6-7 billion on the notification basis, representing about half of the total amount of manufacturing investment abroad. Japanese manufacturing companies have more favourable opinions of the investment climates and performances of their overseas operations in ASEAN NIEs than those in the United States and China.

Another form of Japan's contribution is its provision of a model for economic development to neighbouring Asian countries. The flying geese pattern of industrial development has occasionally been referred to in order to describe Japan's role as a leader and other Asian economies as followers. Indeed, some countries have adopted or emulated Japanese policies and institutions in the field of industrial policy, export promotion policy, and government-to-business relationship, but others have not. A similar pattern of industrial sequencing is observed in many countries, but natural resource-rich countries have different industrial structures at this stage. The term of "flying geese" has been generally used to describe such industrial sequencing and to indicate the direction of industrialization in Asia. However, there has been virtually neither deep dialogue nor strong coordination regarding industrial relocation at the level of governments and private companies.

Further, the recent concentration of Japanese and other Asian manufacturing investments in East Asia should be interpreted as the result of judgments made by particular companies. They have chosen factory and office locations in Asia, taking into account the attractiveness of host countries, as well as the closeness of the markets. Based upon these facts, the economic development of East Asia could be well understood without particularly referring to the flying geese theory. The pattern of industrial sequencing observed in Asian countries could also be observed in other parts of the world with different comparative advantages and at various stages of development, where geese fly individually and not in a V-formation in that case.

III. The future of East Asian economies and Japan's relations

The Japanese economy has suffered from zero or very low growth since the beginning of the 1990s, while East Asian economies have enjoyed high growth in trying to avoid overheating. In the near future, such differences of growth rates will not change much. In 10 years time, the potential growth rate of Japan is projected to be around 3 per cent per annum, owing in particular to the aging of its population. The Japanese Government considers that unless deregulation is pursued real growth will be further slowed.

East Asia, on the other hand, is expected to continue a higher rate of 7 to 8 per cent in the coming decade, if the global and local political situations remain stable and if energy and environmental constraints are not too hampering. However, the greater openness and high dependence on external financial or human resources constitute vulnerable features for some ASEAN economies. NIEs will gradually face the problems of aging and social security, de-industrialization and opening-up of the market which Japan encounters today. The progress of trade and investment liberalization at ASEAN, APEC and WTO will influence the economic management of East Asian economies, which are highly dependent on trade and foreign capital.

Under these perspectives, Japan's relations with this region will evolve and also change. Japanese FDI will be directed more to East Asia and newly emerging Asian markets. New and additional investments will target the local and regional Asian markets more than those of the United States and Europe. Thus, Japanese manufacturing companies foresee the increase of their overseas production ratios. Such assembly industries as automobiles and electronics and electric machinery are already producing 20-25 per cent of total products overseas. The material makers will produce more in East Asia. Whether FDI will replace export or whether it will increase export and import is debatable. The development of exchange rates and other factors will be related. In the light of the recent developments that I mentioned earlier, the interdependence between Japan and East Asia will be reinforced and trade flows will increase.

Financially, Japan's aid will still be an important vehicle, although some countries will graduate from it. Equity investment and other private capital transactions will become major forms. These will be easily influenced by movements in the exchange and interest rates of the US dollar and the Japanese yen, and by regulations and the state of the global economy.

In view of the prospect of deepening interdependence in Asia, Japan and East Asia will reinforce their exchange of views and policy harmonization in the framework of APEC and other forums. This will be a new field to Asian countries and Japan's relations with this region will evolve in both economic and political spheres. ■

Reflections

*V.R. Panchamukhi**

Dr. Robert Rowthorn's (1996) paper makes an interesting analysis of the process of restructuring in production and trade in the Asian region. The main thrust of his argument is that the recycling of comparative advantage from Japan to the first tier NIEs has taken place not through the trade route but essentially through foreign direct investment (FDI). Initially, he refutes the validity of the "flying geese" paradigm by arguing that Japan, having lost its comparative advantage, did not provide a significantly increasing market space for the more competitive labour-intensive products produced in the East Asian economies. In the later part of the paper, however, he has argued that Japanese FDI has facilitated the gradual relocation of industries in which Japan showed the tendency of losing comparative advantage. He has also argued that first-tier and second-tier NIEs are emulating the Japanese role model, although the nature, intensity and content of this emulation may differ. I would like to raise some analytical issues arising out of his very interesting paper.

At the outset, I would like to take issue with Dr. Rowthorn by asking him why he has not included South Asia in his analysis. Unfortunately, most of the analysts discussing economic integration in the Asian region tend to consider the Asian continent only to the right of Myanmar, excluding South Asia. In the second half of the 1980s and also during the 1990s, South Asian economies have been showing consistently high growth rates ranging from 4.3 per cent to 7.6 per cent. The South Asian economies have also extensively liberalized their internal and external policy frameworks. They are now more open to FDI than in the past, and policy reforms are pursued in a consistent manner. With their low level of wage rate and the availability of highly skilled labour, the South Asian economies are now poised to become effective participants in the process of restructuring in the Asian region. Extension of the flying geese model should imply significant relocation of industries from East and South East Asia to the South Asian region. Even though the pace of this relocation has been slow for historical reasons, there is enough evidence to believe that South Asia has now joined the formation of flying geese to occupy the vacated positions. The Republic of Korea, Singapore, Malaysia and Thailand are entering South Asia in a big way. For example, Singapore has established a large computer software park near Bangalore in India. Thailand has been taking a lead role in projecting a growth triangle between Thailand, India and Sri Lanka. There is a growing debate on the bold integration of South Asia with the rest of Asia. In a recent international seminar organized by the South Centre, Geneva, and the Research and Information System for the Non-aligned and Other Developing Countries, New Delhi, the concept of an Asian economic area was mooted and the volume entitled "Towards an Asian Economic Area" has been brought out as a result of this conference. The short point I would like to make is that the flying geese model is in general valid in the Asian region, and in any exercise on futurism South Asia should be explicitly incorporated in the analysis.

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Dr. Rowthorn has argued that Japan has not played a leadership role in facilitating restructuring of production from Japan to the East Asian economies. His argument is based upon the nature of Japan's share in labour-intensive exports from the other suppliers. Japan has been vacating its market in the rest of the world for more competitive suppliers, has moved to more sophisticated product categories, thereby vacating labour-intensive products. I would like to argue that these facts should be considered as forceful evidence of the significant role played by Japan in facilitating the flying geese paradigm of restructuring through the trade route also. Tables 2 and 3 annexed to Dr. Rowthorn's (1996) paper indicate how the share of Japan in the United States and Europe has been declining, while the shares of the Republic of Korea and China have been increasing for the textiles and clothing sectors. Of course, the declining share of Japan need not be interpreted as a conscious decision made by it, but it is still a reflection of the nature of ongoing events in the restructuring process.

Among the issues that need to be analysed from the experiences of both the first- and second-tier NIEs is the question of choice of the right kind of development paradigm which is consistent with the welfare and aspirations of the people. We can perhaps distinguish between three types of development paradigms for convenience of analysis. Firstly, the development paradigm adopted in the first- and second-tier NIEs which has generated high growth but also produced excessive urbanization, a high degree of pollution, large ecological imbalances, and widening income disparities. Should the newcomers in the development process aspire for a development paradigm which leads to more cars than the roads can take and which encourages the tendencies of usurping agricultural land and building skyscrapers in the process of excessive urbanization?

Secondly, one can conceive a development paradigm which assigns priority to the fulfilment of the basic needs of the majority of the population, and carries out growth and structural changes in line with this goal. This paradigm could be described as the "peoples centric approach of development" - a term popularized by the *South Commission Report* of 1990.

The third typology of the development paradigm could be captioned as development with a human face, which would keep employment and poverty alleviation as the core end-products of the development process. The basic needs approach to development and development with a human face are based upon a somewhat similar philosophy emphasizing the imperatives of keeping the goal of enhancing the development capability of the majority of the people as the prime goal. This paradigm would be concerned with the sustainability of the development process and would include some special programmes of safety-nets and support measures aimed at the poorer segment of society. The development process in these paradigms discount the validity of the "trickle down theory" of growth and would directly address the problems of initial conditions of growth, including education, health, housing, sanitation, infrastructure, etc.

The discussion on development paradigms is extremely relevant when dealing with the application of the flying-geese model for restructuring of production in a region. If there is no homogenous uniform development paradigm for all the countries, and if the initial conditions in the laggard economies are such that their economic agents are not in a position to respond positively to the opportunities generated by the vacation of some industries in the leader economies, then there is no automatic application of the flying geese model for restructuring. Thus, the availability of the infrastructure for development, the capability of economic agents to respond to the emerging market signals, the nature of government policies and measures, political stability in the host country and other such factors determine the validity of the flying-geese model for restructuring in the Asian region. One would have liked to see specific discussion of these issues in the debate on the flying-geese model of development.

Having recognized that there is no automaticity in the application of the flying-geese model, one should analyse the role played by the state and in particular its industrial policies in fostering strategic structural transformation in the economy. Recent literature on the East Asian experience and on the Japanese miracle of growth have brought out that the state has played a very significant role in promoting certain sectors which have been identified as strategic ones having significant potential for dynamic comparative advantage. The semi-conductor and micro-electronic industries and consumer electronics in Japan and in East Asia have been encouraged to emerge as those sectors with the maximum comparative advantage because they had received extensive policy support from state actions. Among the lessons to be drawn from the East Asian experience, one should categorically bring out the role played by the state in correcting market failures and in regulating and monitoring the principal market signals. The experiences of the East Asian economies seem to vindicate the validity of recent theories of strategic policy interventions in enabling domestic firms appropriate a larger share in the rents generated owing to imperfections in the international markets.

It is often argued that wage differentials act as a major factor in relocation of industries. However, some of the studies on the determinants of country choice in the relocation of production seem to suggest that import, fiscal and monetary policies towards FDI also play a significant role. As recognized by Dr. Rowthorn, there is a gradual process of wage harmonization among economies. The upward revision of wages in a low wage economy as a result of global integration would soon make it lose its comparative advantage. The period over which this wage harmonization takes place and finally induces the next phase of recycling of comparative advantage was rather large, say four to five years during the recycling process between Japan and first-tier NIEs. However, this period of wage harmonization has been significantly narrowed down recently, which means that the speed of recycling comparative advantage has also increased. Unfortunately, the pace at which knowledge and technology are transferred between a high wage economy and a low wage one has been slowed down. Thus the loss of comparative advantage in the high wage economy owing to high wages would be to some extent compensated by the appropriation of knowledge and technology and the slower pace of their transfer. There have not been many studies on the speed, pattern and relative roles of these two factors, namely wage rate differentials and the technology transfer, in fostering shifts in comparative advantage.

The high speed of wage-harmonization towards higher levels and the slow pace of transfer in technology and knowledge have caused conflicting effects on the process of relocation of industries. At any rate, the low wage economies now entering in the flying geese paradigm of development may find their newly earned comparative advantage to be very short-lived. Further, some countries which have acquired a market share in low-wage manufactures like textiles have been able to do so under the erstwhile trading regime of quotas and other non-tariff barriers. For instance, the relocation of textiles under the multifibre agreements (MFA) regime to take advantage of quotas has nothing to do with the structural shifts as part of the flying geese pattern of development. In fact, some of these economies, like Bangladesh in the case of textiles, may not be able to retain their comparative advantage when the MFA regime has been phased out. It is here that more detailed studies are required about the implications of the new trade regime for restructuring of production and trade across the globe. Unfortunately, Dr. Rowthorn's (1996) paper does not provide much insight into this dimension.

The WTO and the new regime on trade-related intellectual property rights (TRIPs), investment measures and the new issues of social clauses, labour standards, child labour, etc. are likely to act as deterrents in the smooth operation of the flying geese pattern of restructuring. One can substantiate these points with some illustrations. Under the new TRIPs regime, protection of patent rights is much more rigorous than the assertion of the obligation of patent right holders to work their patents. Compulsory licencing of patents has not been given due emphasis in the new patent regime. It is not very clear whether the new TRIPs regime would generate more technological monopolies or facilitate greater technological diffusion and technology transfer. It seems that there would be more technological monopolies on a global scale, and this would obviously slow down the process of relocation of industries. Further, the linkage of labour standards and child labour with trade flows, with the provision for trade sanctions against those countries which do not conform to the stipulated norms, would have the most unfortunate adverse consequences of depriving the low-wage economies of the possibility to assert their comparative advantage in the global market. Thus, the new rules of the game in international trade and investment are likely to influence the process of the so-called recycling of comparative advantage through TNCs and FDI.

Similarly, the trade-related investment measures (TRIMs) has clearly pronounced that the domestic content condition and import-export linkages imposed by the first-tier NIEs and some restrictions on FDI are not consistent with the new GATT principles, and as such should be done away with. Hence, the indigenization process through backward linkage effects of FDI and the gradual emergence of the host country firms as leaders in the dynamics of shifting comparative advantage would be considerably discouraged or at least slowed down under the new TRIMs regime. Some of the stipulations given under TRIMs are very specific in contrast to Dr. Rowthorn's view, and all those which have been stated in a specific manner have significant implications for the process of restructuring in the world economy.

The challenges before the newcomers aspiring to emulate the high growth experiences of the East Asian economies are very complex and diverse in view of the fast changing international environment. One may characterize the emerging international economic environment as a case of four types of explosions. Firstly, there is the market explosion, under which the role of market and competitive forces has tremendously increased in the global setting. Market forces are going to occupy a very significant place in the global economic space. The second type of explosion is in the field of information flows and communication networks. The speed, content and scope of information flows have created an explosive situation, and economic agents are often flooded with huge masses of information which they are unable to analyse, sift and respond to in any rational manner. The third type of explosion may be captioned as the knowledge and technology explosion. In most fields of economic activity, the speed of innovation and technological adaptation has increased tremendously, thereby reducing the period of the technological life cycle and rendering old technologies obsolete in a very short span of time. The capabilities for R&D activities are often inadequate in the newly developing economies, thereby making economic societies technologically backward. The fourth type of explosion is that of standards. Many new standards are emerging, and the standards of products and services are being harmonized with the levels attained in the developed societies. This standards explosion would have a very significant adverse impact on the shifts in the pattern of comparative advantage that could be expected on the basis of resource endowments and stages of development.

In view of the above discussions, it is obvious that the emerging patterns of comparative advantage are not governed by the same or similar factors which were discernible in the global economic environment of the 1970s and the 1980s. Developing countries will therefore have to evolve a new set of policy responses to the emerging world economic scene.

It should also be recognized that the new principles and rules of global economic governance that are embedded in the WTO Agreements have considerably restricted the autonomy of domestic policy makers in the NIEs. The OECD countries have now launched a new demand for a level playing field for direct investment worldwide. According to a European Union document recently circulated among policy makers, the proposed multilateral investment agreement stipulates that the right to invest is to be declared as a legal right for foreign investors and that FDI should be given national and most-favoured nation treatment. Under this investment regime, host economies would be deprived of the right of regulating the flow of FDI into the different sectors as well as monitoring and regulating the impact of FDI on domestic savings, the balance of payments, employment, income distribution, etc., so as to introduce suitable corrective measures whenever the negative impact outweighs the positive one. There is likely to be a significant conflict of interest between the domestic economy and foreign direct investors, and the economically powerful actors would sway the final outcome in their favour.

Analysis of conflicts of interest within countries, between countries, and between countries and TNCs, deserves special attention. I strongly feel that for such situations the game theoretic model is the most appropriate framework for analysing the emerging shifts in strategies and economic decisions by the different actors of the game.

I would like to point out that the approach of growth triangles or subregional cooperation on a fast-track basis has now been emerging as a new framework for economic integration and restructuring of production. In fact, the potential for restructuring at the subregional level goes much beyond the contours of the flying geese paradigm, and more analytical and policy-oriented studies are required for identifying the subregions across the borders of countries where such closer economic integration, based upon natural complementarities and free mobility of factors of production, are possible.

Let me now offer one or two comments on the very interesting and analytically penetrating background paper by Dr. Yilmaz Akyüz (1996).

Dr. Akyüz rightly points out that there has been inadequate effort to integrate the theory of international trade and the analysis of the determinants of FDI. Dr. Akyüz raises a number of important analytical questions: (1) Are the factors influencing the pattern of comparative advantage in trade the same as those which also influence the nature and the pattern of international capital flows? (2) Do foreign firms face the problems of a "level playing field" in relation to the firms of the host country? (The phrase "level playing field" for FDI is borrowed from the new EU document entitled, *A level playing field for direct investment worldwide*, which, as stated earlier, is now under circulation in the policy circles demanding a new investment regime under the WTO.) (3) Would the comparative advantages of firm specific factors exceed the additional costs of operating abroad? (4) Would the traditional interlinkages between trade flows and FDI flows hold good under the new global system of trade and investment flows? (5) Would FDI act as a substitute for exports? (6) Would FDI substitute home investment in the exporting country? (7) Do the international differences in rates of return on investment significantly influence the pace and pattern of international capital movements? (8) What is the interaction between portfolio investment flows and FDI flows?

I have deliberately singled out the above questions and issues that emerge from Dr. Akyüz's (1996) paper since these have great analytical and policy value. I agree with most parts of the analysis and results of the paper. I have, however, some observations to make and some issues to raise for discussion.

The nature of interaction between exports, FDI and home investment is rather sector-specific. To look for some generalized theory on the interrelationships at the aggregate level may hide or distort our understanding of the forces operating in the system. For some sectors, FDI may be the lead event and may not be preceded by export-saturation or followed by more domestic investment. For instance, for consumer goods, such as fast-food chains, the first stage itself is FDI and not the loss of the competitive advantage of exports. Profits generated by FDI produce more FDI elsewhere.

The moot question arising out of Dr. Akyüz's rather pessimistic outlook of Japan's economic scenario is whether its economic society would respond to the mounting pressures by increasing the scale and pattern of domestic demand. The prospects of the Japanese society becoming relatively more consumption-oriented and reducing their savings rate seem to be as bleak as, or even bleaker than, the prospects of the American society becoming less consumption-crazy and developing larger propensities to save. Where does the long-term solution to the growing imbalances in the world economy lie? From the point of view of sustainability of growth the world over and in the interest of a more equitable distribution of the growth-impulses across countries, one has to consider a three-point programme: (1) the United States and other western economies should change their life-styles, meaning consume less and save more; (2) Japan and other countries that have been too rigid in regard to the size and composition of their demand should open up their societies to absorbing goods from the rest of the world; (3) resources generated by these processes should be transferred to those countries which are laggards in development. These dimensions of structural transformation will have to be triggered by deliberate policy interventions and cannot be left only to market forces.

World economic management is now fast moving away from the syndrome of development cooperation to that of development competition. The model of development cooperation would imply that the surpluses should be pooled as development funds and distributed for promoting development, and not invested only to create more profits for the owners of the surplus.

The empirical exercise of Dr. Akyüz to test the "hollowing out" hypothesis in Japan is interesting. However, the specification of the model as a simple linear or log-linear relation between FDI and gross fixed-capital formation (GFCF) is rather intriguing. Firstly, the flow of causality between FDI and GFCF could go both ways. Secondly, there would be lagged effects between them. And thirdly, there could be many other factors which influence FDI flows. However, the fact that the structural break from 1988 onwards that the relationship of complementarity between FDI and GFCF prior to 1987 became one of substitutability is quite revealing.

I am rather optimistic in regard to Japan's ability to respond to the emerging challenges. Japan would do well to move into technological and managerial consultancy services, and thereby facilitate the technological upgrading of poorer economies in Asia and Africa. But the policy prescription made here seems to give the impression that Japan has now reached a dead end. However, Japan can still do a lot by providing development resources to the developing countries. It is, however, necessary that Japan should feel enthusiastic about playing a magnanimous leadership role.

When one asks for greater market access to Japan, one is often motivated to help the United States or other countries with a huge deficit *vis-à-vis* Japan to reduce it. Suppose we conceive another model in which the American people change their lifestyle, reduce their consumption, increase their savings rate, and generate a greater current account surplus. Japan would experience export compression and its domestic industry might experience excess capacity. This situation might induce another round of industry flight away from Japan, but this time to developing countries where the potential demand is still quite high. This alternative model might help the development process in the developing world in a much better way because more resources for development would be available from the surpluses of the United States and other economies.

Notwithstanding the observations made above, Dr. Akyüz's cautionary note on the prospects of Japan to experience a very low growth rate and balance-of-payments deficits in the near future is worthy of serious attention. I would also like to add that more empirical studies are required on the various analytical issues that are raised in his very interesting paper. ■

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Session 2

GOVERNMENT-BUSINESS RELATIONSHIP AND INDUSTRIALIZATION

Chairperson:	*J. Ocampo** Director, Department of National Planning, Bogota, Colombia
Introductory comments:	*Peter Evans* Professor, Department of Sociology, University of California, Berkely, USA
Panellist:	*Liu He* Deputy Director-General, Industrial Policy Department, State Planning Commission of China, Beijing, Peoples' Republic of China
Panellist:	*Kyu Uck Lee* President, Korean Institute for Industrial Economics and Trade, Seoul, Republic of Korea
Panellist:	*Ghulam Mohyuddin* Deputy Chief, Ministry of Commerce, Islamabad, Pakistan

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* Written statement unavailable

Introductory comments

*Peter Evans**

The behaviour of business is not homogeneous across countries. Fundamental characteristics, such as the propensity to reinvest profits and willingness to enter industries characterized by rapid technological change, vary substantially. When this variation is compared across regions, East Asian business has behaved more consistently with the requirements of rapid industrialization than business in any other region of the developing world. On this almost everyone agrees.

Almost everyone also agrees that the nature of the government-business relationship is one of the prime determinants of variation in business behaviour. It follows, therefore, that clearer understanding of the crucial characteristics of the government-business relationship in the East Asian NIEs will constitute an important intellectual resource for countries in other regions trying to accelerate industrialization. But what are the crucial characteristics of the East Asian government-business relationship? And, how can we separate characteristics intrinsic to the specific historical experience of East Asia from more generalizable characteristics that might be utilized in other regions? The hope of being able to answer these questions is a principal motivation for this panel.

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The *UNCTAD Secretariat Report to the Conference* and the background papers on which it is based provide a very promising starting point for our discussions. I am sure that each of the panellists will make important modifications and extensions to the initial framework that has been provided. My own comments here, which reiterate some of the key propositions put forth in the excellent body of material prepared by UNCTAD, are intended to set the stage for the discussion.

Government-business relations may be considered at two levels. At the more specific level, policies define a government's relation to business. Fiscal policy, trade policy, anti-trust policy, and so on, constitute in combination a relationship between government and business. Clarifying which of the many East Asian government policies were most important in shaping the behaviour of business during East Asia's rapid industrialization is the first step towards understanding the government-business relation. Many would argue, however, that it is even more crucial to understand the "institutional prerequisites" that underlie these policies. Not all governments are capable of formulating the kind of policies that were used by East Asian NIEs. An even smaller number have the ability to gain the compliance and cooperation of local business communities which is necessary to implement such policies. Similar policies can have quite different effects when attempted in disparate institutional environments.

The analysis of the "institutional prerequisites" that appear to underlie the effectiveness of East Asia's policy choices is at least as important as the analysis of the policies themselves. Yet, because policies seem easier to change than institutions, prescriptions for improving government-business relations too often stop at the level of policies. Greater emphasis on institutions is clearly in order. Therefore, after the briefest possible synopsis of the features of business-related policy identified as most crucial to East Asian success, I will focus most of my attention on the question of institutional prerequisites.

As the *UNCTAD Secretariat Report to the Conference* and some of the background papers have made clear, the "profit-investment nexus" is at the heart of business-related policy. Business in developing economies does not "naturally" invest at levels consistent with accelerated growth rates, but it can be convinced to do so. Business in developing economies does not "naturally" gravitate into industries where expanded output entails technical change and increased productivity, but it can be induced to do so.

Creating a robust expectation that investment in long-term productive assets will produce returns that are more than commensurate with the risks involved is the first step in generating a high growth profit-investment nexus. Credit, tax, trade and competition policies can all be used to achieve this end, provided policy is consistent, credible and carefully directed. East Asian governments used all of these.

While policies designed to create a credible expectation of high returns are essential, they are not enough. As Latin America's experience demonstrates, such policies are not only insufficient, they can become counter-productive in the absence of a complementary set of policies involving "discipline". Policy must make spending profits on luxury consumption or speculative investments or removing them from the country sufficiently unattractive so that the "nexus" between high profits and high rates of investment in productivity-enhancing industries is maintained.

The institutional prerequisites of the first set of policies (credible profit/rent enhancing policies) are relatively obvious. Close positive ties between business and government, combined with a modicum of competence on the part of policy makers and economic bureaucrats would suffice. There must be institutional ties and individual networks that connect the public and the private sectors, allowing the flow of information from business to government and back. Policy makers must be aware of both the potential capabilities of the local business sector and what is required in order to motivate business decisions.

While the value of such collaborative relations should be obvious on both sides of the public-private divide, they cannot be taken for granted. In many developing countries, anxieties over retaining power lead the "political class" to fear the accumulation of economic assets on the part of anyone who is not their client. Under such conditions, measures to increase the general level of profits (instead of simply rewarding individual clients) will be opposed and even the first step toward generating a "profit-investment nexus" will be out of reach.

If building a basic set of positive ties between business and government were all that was required in order to produce a high growth profit-investment nexus, the institutional prerequisites issue would be less vexing. It is the necessity of combining positive ties with discipline that makes government-business relations complicated. Making sure that high profits and rents are translated into developmental results that will benefit the nation as a whole, rather than being used only to increase the wealth and consumption of those who receive them, requires more than positive relations between business and government. It requires a subtle combination of confidence and scepticism, closeness and insulation, collaboration and autonomy. It requires a government to recognize and encourage the potential of the local business class without taking for granted that "what is good for business is good for the country". It requires a government to have the ability to restrict supply of the good most prized by owners of capital, their "managerial discretion".

A set of institutions which keep the public sector connected to business but still maintains a government's ability to propose and implement collective goals are at the core of the institutional prerequisites of the East Asia model. This is what the *UNCTAD Secretariat Report to the Conference* describes (p.14) as "a robust network of government-business institutions consistent with strategic development goals". One of the foundations of such a "robust network" is a coherent, capable bureaucracy on the government side. Unless careers in public service are rewarded to a degree commensurate with what individuals of comparable talents can expect to receive when they pursue private interests, government cannot play the role required to sustain the "profit-investment nexus". Unless civil servants are recruited meritocracy, inculcated with a sense of the value of the job they are doing, and consistently rewarded for contributing to the goals of the organizations for which they work, government-business networks quickly break down into clientelistic sets of individuals trying to ensure their own well-being without regard for the impact of their actions on any larger collective project.

Is this particular institutional prerequisite beyond the reach of other developing countries? Many argue that it is. These arguments are, however, suspect. Those who make them often seem to be arguing for the impossibility of creating capable public institutions, in part because they do not really believe in the value of such institutions to begin with. The *UNCTAD Secretariat Report to the Conference* takes the more reasonable view that while the task of building and sustaining public institutions is unquestionably a daunting one in most developing countries, the level of competence and rectitude required to construct a profit-investment nexus comparable to that achieved by the East Asian NIEs is not necessarily beyond reach. Several points need to be underlined here.

First of all, the *UNCTAD Secretariat Report to the Conference* emphasizes the fact that, while East Asia has benefited from a long tradition of meritocratically recruited public service careers, its bureaucrats are by no means "super human" either in terms of ability or of rectitude. Prior to their recent economic success, East Asian bureaucracies were justifiably denigrated as tradition-bound, ineffectual and corrupt. It is equally obvious, even without recent revelations of high levels of corruption in the Republic of Korea, that even the best performing contemporary bureaucracies are not immune to unscrupulous behaviour.

The transformation of public institutions into paragons of analytic brilliance and virtue is *not* a prerequisite. Even very crude approximations to competence and probity may be sufficient to generate productive government-business relations. Given this more realistic goal, the state bureaucracies of other developing countries appear less hopeless. In fact, existing public bureaucracies, certainly in Latin America and even to some degree in Africa, are not uniformly the cesspools of incompetence that they are sometimes painted by neo-liberal rhetoric. There are dedicated individuals working in public service in almost all countries. More important, most bureaucracies contain institutionally admirable pockets of efficiency. Individual agencies and organizations in many developing countries have often performed with levels of efficacy comparable to those of their East Asian counterparts, despite being surrounded by a public sector that is ineffectual overall. Almost every country has something to build on.

Recognition that coherent, capable public institutions are a scarce resource that must be nurtured and conserved is the first step in building institutional prerequisites on the government side. Public institutions have to be nurtured with the same fervour that plant, equipment and human capital are nurtured. One of the most deleterious consequences of current neo-liberal theorizing on development is that its less sophisticated adherents interpret it to mean that crippling public agencies is not just an inconsequential side effect of fiscal austerity; it is a positive benefit. This kind of thinking will certainly put the institutional prerequisites of the East Asian profit-investment out of reach.

Increased awareness that a public decision-making capacity is a scarce resource should underline the importance of conserving this resource. Appreciating the difficulty of building capable public institutions means appreciating the value of the careful selectivity with which East Asian bureaucracies involved themselves in the development process. One of the detrimental effects of the "development planning" ethos of the 1950s and 1960s was to encourage third world states to undertake a range of projects and responsibilities far beyond their institutional capacity. Consequent failures helped undercut the legitimacy of public institutions and generate a downward spiral in which repeated failure further undermined capacity. Bureaucratic performance will not improve until the implicit assumption that public decisions are "free goods" is firmly exorcised. At the same time, however, it must be recognized that "learning by doing" is a characteristic of all organizations, not just firms. Tasks should be carefully selected, but avoiding challenges leads any organization to atrophy.

Obviously, competent government organizations cannot construct an effective system of government-business relations without comparable private counterparts. Entrepreneurial resources also need to be nurtured. What the East Asian experience suggests is that there is a symbiotic relation between the strength of the entrepreneurial sector and the strength of the public sector. Entrepreneurial acumen certainly did not appear to be in any greater supply in the Republic of Korea in the 1950s than in Brazil or India. Disorganized states lead to disorganized business communities. Coherent public policy helps to organize the business community. If other developing countries can solve the public sector side of the institutional prerequisites problem, their chances of solving the private sector side would seem excellent.

If we can agree that effective government-business relations analogous to those that emerged in East Asia during the post-World War II period may in principle be within reach of many other developing countries, another question arises. Can such institutional arrangements still make a difference in the globalized, post-WTO world? This is a debate worth having. Clearly there are new challenges. The policy options open to governments are restricted. It is easier for local business elites to abandon local ties for new transnational alliances. Still, it should be noted that the changes are not all negative. Certain aspects of the "discipline" side of the government's role have been made easier. The Latin American syndrome in which the government supplied local industry with the conditions necessary to make high profits but was never able to extract the *quid pro quo* of accelerating technical change and productivity growth is much less likely in an environment where protection from international competition can be temporary, and partial at best.

In the end, the diffuse ideological consequences of the new global environment may prove as consequential as concrete changes in the international rules of the game. Along with the sectoral agencies and deliberation councils that helped steer the profit-investment nexus, a shared sense of national purpose played a role in the East Asian cases that is harder to pin down but no less important.

Industrialization was a "national project" at the ideological level as well as at the level of policy and programmes. The conviction that such a project was both desirable and achievable helped legitimate longer-term horizons, greater willingness to take risks and constraints on consumption.

Today, the dominant view of the global environment inculcates the belief that unquestioning conformity to the immanent logic of international markets is the only option open to developing countries. In this view, national projects become quaint anachronisms of a bygone "pre-global" era. If business accepts this view, conformity with governmental constraints, instead of being a contribution to a joint project of industrialization, becomes simply onerous acquiescence to parochial illusions of grandeur. For public bureaucracies, this view turns any effort to change the "natural" rhythm of accumulation into a fruitless fantasy.

If the ideology of the "development planning" era undercut the capacity and legitimacy of governments by tempting them to try to do too much, the ideological order of the post-WTO era seems likely to reduce public capacity through the reverse process. "Unlearning by not doing" is as potent a process as "learning by doing." Once they are convinced that they cannot affect their destinies, developing country governments will almost inevitably become ineffectual in fact. ■

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The changing role of the government and industrial policy

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It is a great pleasure to participate in the panel discussion on the topic of government and business relations, for which the three excellent papers had been prepared. As a Chinese adviser for industrial policy, I am eager to learn about the experiences of other NIEs, and should like to share some of my expertise on China's economic development. First, I would like to give my impressions on the papers presented to this Conference and present a question on each of them. Then I shall make some simple observations on industrial policy based on China's experiences.

After reading the three papers, I am glad to say that I have benefited a lot from them and got a deep understanding of the Asian economic miracle. The paper by Y. Akyüz and C. Gore (1996) emphasizes the role of government in maintaining the domestic savings rate and promoting the profits to be channelled into investment. The paper argues that the corporate profits and other profit-related incomes were the main source of investment in the most successful East Asian economies. Government policy has played a major role in promoting capital accumulation by creating rents. This has been achieved through a broader set of measures than those usually identified as selective industrial policy. My impression on this finding is that the mechanism not only leads us to follow the right policy direction, but presents a way of thinking that provides us with the generalities of the real and meaningful things, instead of falling into the pitfall of small items. One question here is whether, in the cases of Japan and the Republic of Korea, it is possible to separate investment promoting policies from selective industrial policies?

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The paper by K.S. Jomo (1996) has also benefited me with an integrated study on both the first and second generations of the "Asian miracle" creating countries. Previously we had almost been convinced by the conclusion of the famous World Bank report that the open trade system and market friendly policies were the main sources of the economic growth in South East Asian countries. But after reading the paper, we now realize that liberal policies are of course crucial for economic success, but that they are only part of the story. Without the expansionary industrial policies of Japan, there would be no Asian miracle generated by the later comers. It is important for both economists and policy makers to explain the reasons for their economic development from a broader angle so as to avoid the mistake of "blind people touching an elephant". It is also wise to use the framework of interdependent international economies in analysing domestic economic issues. A question still remains as to whether developing economies can still implement some old fashioned industrial policies to promote their economies under the new rules of the WTO.

The paper co-authored by T. Chang, S. Haggard and D. Kang (1996) gives us a clear description of the institutional innovations in both the Republic of Korea and Taiwan Province of China. I understand that contrary to the smaller government argument, a strong, competent and meritocratic bureaucracy has also been crucial to fast economic growth and development. The government is no longer just a passive judge, a lonely watch-dog, but could be a good organizer and active player in many areas. One interesting question is why the elites of the Republic of Korea and Taiwan Province of China would like to remain engaged in public service instead of jumping into the business field for much higher returns.

Let me go to the issue of the role of government, particularly in industrial policy. In these we can easily find that in creating the Asian miracle, governments have played a leading role to promote economic development. They have not only acted in some traditional areas such as maintaining macroeconomic stability and supporting the formation of the market system but also stepped into some new areas that have been treated as untouchable by neoclassical theory. We have heard so much from these papers about the new and brave ventures: for example, changing the savings and consumption pattern in Singapore; direct controlling and changing the position of the entrepreneur class in Taiwan Province of China; direct control over the behaviour of commercial banks in the Republic of Korea; strong intervention in private investment in Japan. Two things are clear. First, in some developing economies at a certain developing stage the leading class for growth is not that of entrepreneurs but of bureaucrats. That the bureaucratic class may play the dominant role is also true in my own country. Second, we must also see that the new areas opened by NIE governments are not as long-lasting as their traditional counterparts. After the economy's take-off, gradual exit out of the new areas is crucial for further economic development. When to step into and when to step out of these new areas is simply an art; no theory can give you the right answer.

Let me talk on two issues related to industrial policy based on China's experiences. First, the effects of selective industrial policy and, second, the government's intentions for industrial policy. After the founding of the People's Republic of China, implementation of its industrial policy may be divided into four phases. From 1950 to 1978, the government implemented the heavy industry priority policy by creating rent for heavy industry at the cost of light industry and agriculture. As a result, the ratio of heavy industry to GDP became much higher than needed, and the national economy almost went into a crisis caused by the structural imbalance. From 1978 to 1984, the government undertook a market-oriented reform with a new industrial policy to restructure the economy and promote the agricultural sector. The agricultural sector faced favourable policies, including privatizing land and establishing the family contract responsibility system. The latter system forcefully stimulated production and investment activities and expanded the domestic market. The result was quite good. From 1985 to 1992, the government maintained an open-door policy both to promote export and to welcome capital inflow through many different policy instruments. A host of measures were also used to improve the infrastructure. During this period, while still using many "market-distorting" instruments to support industrial priorities, the market system began to emerge and eventually even played a stronger role than the government in various public investment fields. Even though the invisible hand began to play its role, the consequence of the government's industrial policies was nevertheless still very effective. The growth rate of GDP was higher than 10 per cent, and the people's income doubled.

It cannot be said that the high growth of the economy was totally due to the implementation of the industrial policy, as other reform policies also played important roles. Yet without the above-mentioned industrial policies, especially the open-door and infrastructure promoting policies, the economic performance would not have been as good as it was. It is wise to separate two different types of industrial policy: the functional industrial policy to support the formation of the market system, and the discriminatory policy of direct control. For China, the second type of policy has been much more efficient than the first.

Let me move to the second question, i.e. the future of industrial policy in my country. From 1992, the government has taken a further step towards perfecting the market system. Meanwhile, it has also tried to obtain membership in WTO. The industrial policy has now been treated as a tool for organizing the market system during the transitional period, and for creating a better investment environment for domestic and foreign investors. Policy makers in the central government now want to shift the emphasis of industrial policy from encouraging a specific sector or industry to perfecting market orders and operations. In other words, we want to create a market friendly industrial policy, instead of continuing to implement the policy as a substitute for the market instrument. For example, in the next five years, we should like to deal with the issue of opening up the telecommunications sector, and to welcome private competition in the manufacturing industry though industrial policies. We should also like to disclose more information on industrial policy in order to facilitate the decision-making process of investors.

There are four reasons for this change. First, China will join the WTO in due course and would like to follow the rules of the organization. Second, as economic organizations have been decentralized in China, the government can no longer implement the old-fashioned industrial policy. Third, along with the formation of a market system in a large country, policy-makers have been more concerned with the distribution effects of the government's policy than growth effects. Finally, the selective industrial policy may be useful for the production capacity formation, but its impacts on R&D is hard to say. As China's economy moves from the extensive pattern towards an intensive one, more enlightened policy is badly needed.

Finally, I have one suggestion. We need a clear definition of industrial policy. We have seen that, apart from the monetary policy, almost all sorts of public policies have been called industrial policy. Under such a definition, it is hard to have a focused discussion. ■

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Remarks on the government-business relationship in the Republic of Korea

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I. Introduction

The Republic of Korea has successfully attained a high rate of economic growth over the past several decades, thanks to the concerted efforts of all economic agents. It is widely held among development economists that the Government of the Republic of Korea has played a central role in achieving this result. However, we do not know whether the country's economy would have fared better or worse if the government had adopted policies different from the ones actually implemented. Nevertheless, I am inclined to believe that the economy would now be in a better shape if the government had rectified its policy errors promptly and had been organized better. With this in mind, it will be worthwhile to critically review how the government-business relationship has evolved in the course of the economic development of the Republic of Korea.

Up until the 1970s, the government was in charge of the overall operation of the economy where private firms played a rather passive role. In general, the government's corporate policies during this period were designed to provide direct assistance, while imposing regulations on selected industries and firms. Moreover, from 1975 to 1979, in the aftermath of the first oil crisis, the government tightened its grip on the economy by enforcing wide-spread price controls.

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However, as the economy expanded and became more sophisticated, direct regulations became less effective and more detrimental to autonomous industrial growth. The rationale for government intervention was further weakened by improvements in the capacities of the private sector. Moreover, the growth-first economic policy widened imbalances between industries, firms, regions, and income groups. Under these circumstances, the government realized that a market mechanism, rather than its planning, should play a central role in allocating resources. Therefore, the government began liberalizing many areas in the economy. Most importantly, it expanded import liberalization and promoted competition among domestic firms. The latter half of the 1970s marked a turning point in the transformation of the "government-led" economy into a market economy. The basic tenet of corporate policies also changed from direct preferential intervention to indirect general incentives. This fundamental shift in policy orientation has accelerated since 1988, in line with a growing demand for political and economic democratization. However, this was only the beginning. The Republic of Korea has currently taken on the additional task of restructuring its economy in order to become an advanced country. It will require not only a physical transformation of the industrial structure, but a whole array of institutional innovations and the active implementation of competition policies necessary for a full-fledged free market economy. Korea's economic future will depend on how successfully the government can implement these policies.

II. The characteristics of industrial organization

The government policy of promoting rapid economic growth has placed a higher priority on large firms than on small and medium ones. This policy inevitably has led to monopolistic or oligopolistic market structures and to a concentration of economic power. In addition, trade associations have exercised a substantial amount of influence over the economy. Most trade associations tended to act collectively with questionable economic justifications in determining prices, adjusting production, and restricting the number of new entrants into a given industry. These collective actions have often been taken with the power of *ad hoc* laws for individual industries, or at least with the tacit consent of the government. The convenience of this practice has been accepted by both the government and business, since the former only had to deal with a small number of trade associations, while individual firms did not have to compete with one another.

The most distinct characteristic of industrial organization in the Republic of Korea is the concentration of economic power, embodied in and symbolized by conglomerate business groups, known as *chaebols*. The birth and growth of a *chaebol* can be explained by a few elements. In the initial stages of economic development, a particularly important entrepreneurship was required to obtain and utilize inputs that were not fully transacted in the market. Entrepreneurship became even more valuable as the target rate of economic growth was raised, and hence the demand for "gap-filling" and "input-completing" functions also increased. Moreover, the supply of entrepreneurs by nature is not elastic. Nor is inherent entrepreneurship easily exhausted, despite its repeated use. As a result of such peculiarities, economic power was naturally concentrated in the hands of a few.

The concentration of economic power can also be traced to the *chaebols'* diversification. While better manpower and physical resources were concentrated in monopolistic and oligopolistic firms, various structural and institutional barriers protected these firms' initial monopolistic market enclaves. The early monopolists and oligopolists expanded into new markets to make use of their excess capacity in manpower and capital as competitive pressures were eliminated in their already existing markets.

The government is also responsible for the concentration of economic power in the country. Because the strategic industries emphasized by the government required huge capacities in technology, capital, manpower and organization, *chaebols* were favoured over other firms. It was then natural for the benefits of tax, credit and trade policies to accrue primarily to the *chaebols*. The weak stock market also served to cement the ownership of the *chaebols*, since the need for rapid growth inevitably rendered a high dependence of firms on external financing. Because of this financing method, the ownership of the *chaebols* has remained concentrated, a phenomenon further aggravated by intercompany shareholding.

There is no doubt that the *chaebols* have contributed to the national economic growth. However, they have also given rise to adverse and undesirable side-effects. Wielding their greater market power, *chaebols* have sometimes eliminated smaller independent competitors from the market. Another often-observed negative effect is the chain of bankruptcies of an entire *chaebol* triggered by the financial failure of a subsidiary firm. The financial interdependence within a *chaebol* tends to build high exit barriers, and scarce economic resources are often inefficiently diverted to rescue a subsidiary from bankruptcy in order to avoid even greater problems.

The general public believe that most *chaebols* have accumulated wealth thanks to the helping hand of the government and that they are often tainted by corruption. The recent disclosure of the secret slush fund amassed by two former Presidents seems to support such a popular notion. This implies that the *chaebol* issue has evolved into a political and social dimension. However, this scandal will only serve to strengthen the efforts of the Government of the Republic of Korea in taking some important steps towards a more transparent, competitive market system. By coming up with a new paradigm for the government-business relationship befitting cleaner politics, the country will be able to regain its momentum of rapid growth.

III. Competition policies

Although the markets of the Republic of Korea were generally non-competitive, relevant policy issues came on the surface only after the country was hit by the first oil crisis in 1974. The severely distorted market mechanism and a sharp increase in the prices of imported raw materials caused inflation and demand-supply imbalances in many markets. The government, therefore, added emphasis on microeconomic policy on top of traditional macroeconomic policy. In essence, the government attempted to monitor selected individual product markets and apply appropriate policy measures. The Price Stabilization Act of 1975 was the legal foundation for this new economic policy.

This Act had various side-effects, since it placed heavy emphasis on the regulation of prices, i.e. the element of performance rather than the structural aspects of market. Direct price controls on a wide range of commodities went beyond the limits of administrative capacity and led to a series of problems. Long-term price controls severely distorted the price mechanism, and gave rise to phenomena such as dual pricing and the deterioration of product quality, as well as chronic excess demand. Furthermore, most regulated firms lost interest in expanding production and consequently placed less emphasis on capital investment, which further weakened their ability to weather business cycles.

This experience, coupled with the second oil crisis, prompted a reappraisal of the past performance of the economy of the Republic of Korea and led to the general consensus that the market mechanism should play a greater role in the economy in the coming decades. The first major effort in this direction was the Fair Trade Act enacted in April 1981, which nullified direct price regulations under the Price Stabilization Act, and set new comprehensive "rules of the game" for the market economy - namely, free and fair competition.

The Fair Trade Act provides concrete measures to prevent the abuse of a market-dominating position and the excessive concentration of economic power. It also controls collusive activities and prohibits unfair business practices. Therefore, this new Act signified a fundamental change in the government-business relationship. It should be pointed out that while the Act basically removes public intervention in the marketplace, it also precludes the dependence of individuals on the government. Deregulation has fundamental significance in this regard, which will be discussed later.

In addition to the Fair Trade Act, a "specialization policy" for the *chaebols* was introduced in 1991 and reinforced in 1993. This policy was aimed at curbing the *chaebols'* "octopus-like" diversification. The policy dictates that the 30 largest *chaebols* select their "core industries" and "core companies", which are allowed exemptions or preferential treatment with credit control and equity investment regulations. Thus, the specialization policy does not directly attack diversification. Rather, it allows the *chaebols* to naturally focus on a small number of key industries through specialization. This policy has come under harsh criticism for its lack of theoretical and practical justification. However, the government has maintained this policy on the belief that it will help the *chaebols* to restructure their businesses for global competition.

IV. Economic deregulation

In pushing for rapid economic growth, the government imposed regulations on industries mainly to prevent "excessive" competition. The regulations served the purposes quite well in the early stage of development, when the economy was small and the capabilities of the private sector had not yet matured. Continued on a broader scale, however, the regulations became detrimental to efficient business activities. The inflexible bureaucracy in charge of regulatory administration has not been able to adjust to rapidly changing economic conditions, while the very rationale for regulations has lost its meaning. At the same time, under these circumstances vested interests began to appear, especially in connection with the legal barrier to entry and preferential government support for strategic industries.

In response, the government attempted to improve the regulatory system in the early 1980s. Nevertheless, such efforts were only partially effective, since the government did not examine the validity of regulations *per se*, but merely tried to reduce red tape and paperwork. In the latter half of the 1980s it became increasingly obvious that deregulation was necessary as an essential means of achieving economic democratization and strengthening international competitiveness. In 1988 the government began deregulating industries.

The philosophical foundation for deregulation was laid down by the Fair Trade Act. It does not aim for deregulation *per se*, but its spirit and logic naturally lead to deregulation. The Act stipulates that government agencies must consult with the Fair Trade Commission before they introduce or amend any laws or decrees that may have anti-competitive effects.

Since President Kim came to power in early 1993, the practical need for deregulation has been felt ever more strongly within the government, so as to enhance economic efficiency. To demonstrate its commitment to forming "a small but strong government", the current government restructured itself at the end of 1994. The most notable example was the merging of the Economic Planning Board and the Ministry of Finance into the Ministry of Finance and Economy. This new, powerful ministry is responsible for formulating and implementing a comprehensive programme for deregulation. In doing so, it must pay greater attention to removing legal entry barriers rather than eliminating administrative red tape.

The removal of anti-competitive public intervention cannot be achieved through just one policy shift. It is a task that has to be implemented on a continuous basis until viable competition is firmly established in the economy. In order to implement deregulation measures more effectively, many real-world obstacles need to be removed. First, we must find out exactly what to deregulate and why. Although many may benefit from deregulation, it is often very difficult to estimate the magnitude of such benefits or to induce those people to form a well-organized lobbying group advocating deregulation with a solid foundation. Much of the resistance to deregulation has come from business people well organized to protect their vested interests, and from those benefiting from the past anti-competitive regulations in their markets. For the implementation of deregulation programmes to be effective under these circumstances, it is very important to raise public opinion in favour of deregulation through seminars and public hearings, and to present complementary policy measures that can minimize the adverse effects of deregulation on particular interest groups.

In addition, it is also important to monitor the process of deregulation once a policy has been adopted. Perhaps more important than deregulating existing anti-competitive public interventions is a constant review of new laws, ordinances and administrative measures, so that they do not form a new body of anti-competitive measures.

The proponents of deregulation have long argued on an ideological or theoretical basis. As the effects of deregulation become visible and tangible, however, proponents will be armed with concrete evidence on the effectiveness of deregulation that the general public can easily understand. The remaining task is to persuade decision-makers, legislative as well as administrative, to take more effective and speedier deregulatory measures.

V. Concluding remarks

We have so far reviewed some important aspects of government-business relationships in the Republic of Korea. Its evolutionary path can be described concisely as a steady progress towards overall economic liberalization commensurate with a free market economy. Towards the end of the 1970s, the government realized that it had to bring the country into a new economic system that respected free market mechanisms and the freedom of the people to make their own decisions. In the area of corporate policies, the government vigorously promoted liberalization and competition on both the domestic and foreign fronts. This reorientation, as part of a move towards "economic democratization", was further solidified as political democratization began to gain momentum in 1988. In general, the experience of the Republic of Korea suggests that a fair and competitive economic order cannot be developed separately from a democratic political system, since they share a common philosophy and logic.

It is sometimes argued that a monopoly is necessary to obtain efficiency, whereas competition tends to be wasteful in the early stages of economic development. Although the logic of this argument cannot be entirely denied, it should be noted that eventually an "artificial" monopoly not only hampers economic efficiency, but more importantly it discourages the competitive spirit of society that is the real engine of economic growth. Private monopolization through public intervention can give rise to a community of interests and concomitant "government failures", which cannot be easily eliminated in a society marked by traditional communitarianism and bureaucratic authoritarianism. A competition policy should, therefore, be assigned a foremost position on the agenda for self-sustaining economic growth. Unless the general public is market-minded, market-oriented economic policies cannot succeed.

Finally, it seems appropriate to discuss several remaining tasks for the competition policies of the Republic of Korea. First, in the light of its complexity arising from its convoluted origins and close entanglement of advantages and disadvantages, the concentration of economic power has to be addressed through a steady implementation of comprehensive policies, including not only the strict enforcement of the Fair Trade Act but also the reformulation of other measures, such as the elimination of entry barriers, more stringent tax administration, more equitable allocation of financial resources, and the removal of restrictions on imports. Beyond these measures, in order to eliminate the major negative effects caused by the concentration of economic power, more competitive pressures need be imposed on business groups by encouraging the entry of domestic as well as foreign firms. The countervailing power of small and medium-sized firms, labour unions and consumers also has to be augmented. These measures can force business groups to disengage from anti-competitive or inefficient market conduct.

Secondly, regulation or deregulation must be continuously reviewed in response to ever-changing technologies. What, when and how to deregulate should be discussed in an open forum to eliminate the undue influence of vested interests, both public and private. Deregulation should, in principle, be simultaneously enforced across the industries concerned. Otherwise, resources will tend to concentrate in a few deregulated industries. Attempts should be made to minimize adjustment costs for producers and consumers who will be adversely and directly affected by deregulation. Deregulation must also be enforced with a close link to import liberalization, since both measures serve to open a market to competition. Deregulation does not imply simple *laissez-faire*, however. On the contrary, competition policies must be strengthened to guard against abusive conduct by market dominating firms.

Thirdly, competition policies, while based on the Fair Trade Act, must also be coordinated with other policies. Insofar as this policy provides the most fundamental framework for market order and contains elements of general industrial policy, other industrial laws, such as the Copyright Act and the Patent Act, must be recast and enforced within the boundaries set by this Act. Currently, activities "justified" by such laws are exempted from the Fair Trade Act. In a similar vein, external trade policies must be harmonized with internal competition policies. Attempts to discriminate between the two types of policies would be futile in an open economy. ■

Comments

Ghulam Mohyuddin[*]

It is universally recognized that the nature of government-business relationship is critical for the economic development of a country, whether developed, developing or undeveloped. The facets as well as the factors determining this relationship are multifarious primarily because this relationship evolves within the socio-legal milieu and politico-cultural framework of a country. Whereas this relationship has been quite fluid and flexible in the intertemporal sense, the level of complexity of this relationship has grown over time so much that this complexity has led to the emergence of the new approach to the solution of economic problems which goes under the rubric of "good governance".

There is a general consensus among political scientists and economists that non-economic constraints are as significant as economic constraints to economic development. For this reason, the issue of government-business relationship has drawn the increasing attention of policy makers and development analysts in recent times. In this context, macro-management as well as institutional changes have been prominently dramatized by the traumatic transition of Eastern Europe.

Analysis of the industrialization and growth performance of developing countries highlights the enduring and endemic nature of the developmental problems that are basically rooted in their systems. These include: an ineffective and uncertain policy framework, the inability of legal systems to provide timely recourse, the weak institutional capacity to anticipate events and conceptualize policy, the narrow based and slow decision-making.

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The issue of governance, which has a direct bearing on government-business relationships, can be discussed in the following framework.

Institutional space: This affects the degree to which the monitoring system is influenced and correctly reflected by economic decisions or transactions, so that the responsibilities of the state are discharged. Another dimension is whether the decision-making mechanisms are in an institutional framework or discretionary in character.

Institutional capacity: The ability to conceive, lead and manage change, including strengthening of the system's decision-making abilities and providing an environment for efficient economic activity.

Institutional efficiency: The ability to achieve policy objectives without excessive cost and to carry out assigned functions with minimum system losses.

My presentation would mainly concentrate on the experience of my own country, Pakistan, in the sphere of resource mobilization and industrialization.

Domestic resource mobilization is one of the key determinants of sustained economic growth. Pakistan's performance with regard to domestic resource mobilization has been poor despite maintaining a respectable economic growth rate. In fact, its savings rate is one of the lowest in developing countries, and policy makers are faced with the problem of harnessing sufficient resources for financing economic development.

Savings are critically important to help to maintain a high level of investment, which is a key determinant of economic growth. During the last two decades, the saving rate has fallen sharply in many developing countries. Pakistan presents a unique picture of experiencing a high rate of economic growth coupled with a low saving rate. The domestic saving rate has fluctuated around 11 per cent during the past 15 years. The current rate of about 14 per cent of GNP in Pakistan fares badly compared with other developing countries such as the Republic of Korea, Singapore, Malaysia and India. Yet, Pakistan's economic performance during the 1980s was impressive on a broad basis and, despite many setbacks, it maintained a reasonable growth during the first half of the 1990s. Thus, Pakistan's savings performance and its overall economic performance appear to be incongruous.

Similarly, on the external account, Pakistan's export performance has also not been matched by many countries in the region, including Malaysia, India, Nepal and Sri Lanka. Reasons for high consumption and low savings are multidimensional, including (1) ineffective demand management leading to conspicuous consumption and ostentatious living standards, (2) modern cultural and social trends supporting high consumption, (3) low literacy rate, and (4) a rate of inflation which has been higher than the interest rate on savings.

Domestic savings have been able to finance, on average, three-quarters of gross domestic investment in Pakistan during the past 14 years, while the remaining one-quarter has been financed by foreign borrowing.

The present industrial policy of the government clearly speaks of the government-business relationship with the main thrust on the participation of the private sector in the industrialization efforts of the country. Its salient features are: (1) to fully protect foreign and local investors; (2) not to restrict private investment in any sector except in defence-related and sensitive areas; (3) to let the private sector play a dynamic role in economic development; (4) to promote public and private partnership; (5) to place the emphasis on assisting backwards and developing areas; (6) to shift gradually from traditional sectors to heavy engineering value-added and high-tech industries, with free market forces being allowed to decide prices and profits for optimal utilization of industrial potential; (7) to review interest rates and collateral requirements; (8) to establish a bank to help engineers, artisans, craftsmen, etc., to set up small industries; (9) to promote joint ventures with multinationals and encourage the establishment of export-oriented industries; (10) to make it compulsory for the rural sector to spend on research and development; (11) to create a special corporation to rehabilitate ill-performing and bankrupt industries; (12) to reduce illegal smugglings to protect local industry; (13) to improve the law and social order as well as infrastructural facilities so as to attract foreign investment; (14) to identify new geographical areas of industrial development; and (15) to phase out government controls over prices and investment decisions, reduce subsidies and introduce special incentives to promote export and healthy competition for domestic and foreign investors.

With the new industrial package, the sanction of the government will now be required in respect of defence-oriented and sensitive areas. As a result of the above deregulatory measures, entrepreneurs are now free to select and set up industries of their choice. In addition, there are a number of informal networks. For instance, ties between the government and business have been reinforced by such a practice that officials leaving the bureaucracy on retirement take up high-level posts in private industry and associations.

The economic and social reforms introduced by the government aim to transform the economy to achieve a new equilibrium at a higher growth rate. The government endeavours to raise savings and investment, reward efficiency and release economic resources and potentials for the rapid industrialization of the country, in particular in rural and underdeveloped areas.

Pakistan has gone through an interesting journey. We started with a thrust for capitalism during the 1950s. During the 1960s, we pursued a strong orientation to promote the private sector. During the 1970s, the nationalization of banks, insurance, industrial and commercial sector enterprises was carried out, but in the following decade the reversal of the 1970s policies was undertaken. The three "Ds" in currency in the 1990s are deregulation, disinvestment and denationalization. The government now believes in these three "Ds", but its manifesto places emphasis on public-private partnership. This approach appears to be right, as a socially responsible private sector is on today's agenda.

The basic thrust of the new economic reforms now is on privatization, deregulation and unleashing the potential of the private sector by encouraging greater private savings and investment, to accelerate economic growth, while maintaining macroeconomic stability. At the same time, renewed and determined efforts are being made for human resources, physical infrastructure development and environmental protection.

The broad objectives of privatization and deregulation include creating a liberal economic environment, removing trade and tariff barriers, improving national productivity, achieving rapid industrialization, facilitating access of the private sector to financial resources, improving efficiency, effectiveness and profitability, insulating the economy from political interference, developing a viable capital market and releasing resources for the social and physical infrastructure.

The normal job of the government now is to facilitate economic activities rather than to compete or interfere unduly with such activities. The beneficial effect of privatization includes improvements in the productive efficiency of state-owned enterprises, relieving the exchequer of the financial burden of inefficient enterprises, and encouraging private initiatives. In the re-definition of the roles of the government and private sector, deregulation is as important as privatization. Instead of devoting energies and resources to designing and implementing unnecessary controls over the private sector, the government will play a more promotional role. This way the private sector will be able to concentrate more on increasing production and efficiency and less on dealing with circumventing government regulations.

A comprehensive package of incentives and concessions has been provided to foreign investors, which are second to none in the emerging capital market. They can avail fiscal and monetary concessions *at par* with their local counterparts and enjoy greater choice in the selection of areas for investment. The Pakistani rupee has been made fully convertible on the current account and for all investment and debt-related transactions. Now there is no restriction on bringing in or taking out of Pakistan any amount of foreign exchange, capital gains, returns on equity and debt-service payments, which are freely repatriable.

All industrial fields are now open to foreign investors, including power generation, its transmission and distribution, as well as oil and gas exploration and mining, etc. However, few activities such as agricultural land, forestry, irrigation, real estate (including housing), commercial and housing construction, radioactive minerals, insurance, health and allied activities, have been placed on the negative list for foreigners. There is also no restriction on the quantum of foreign equity, as all projects in Pakistan can now be set up even with 100 per cent foreign equity.

A fully developed export processing zone (EPZ) has been set up near Karachi, which is functioning successfully. It has been fully developed and all basic infrastructure facilities, including a 2000-lines digital international subscribers dialling exchange, has been made available in the zone. Only those industries established for the entire export of their output are eligible for availing benefits, incentives and concessions in the zone. Resident Pakistanis are allowed to invest up to 100 per cent in the joint ventures to be established in the zone. Two more EPZs are being planned near Lahore and Peshawar.

With a view to accelerating the pace of industrial investments, generating exports, ensuring transfer of technology and creating additional job opportunities, the government has planned to establish 12 special industrial zones (SIZs) over the country where all infrastructural facilities would be provided. A wide range of incentives and concessions has been provided in these zones to attract investment, including an income tax holiday for a period of five to 10 years, exemption of customs duty and sales tax on imports of plant and machinery, capital gains exemption for a period of five years, concessions on excise duty, reductions in income tax by 15 to 20 per cent on dividends on shares of a company set up for power generation, etc.

For the promotion of investment activities, the Board of Investment (BOI) has been assigned the following functions: (1) to formulate policies to make Pakistan a safe and attractive place for investment; (2) to identify investment opportunities and provide services; (3) to offer a one-window facility for the provision of all services and utilities to investors, including the development of industrial estates; (4) to coordinate all private sector programmes/projects in different government agencies; and (5) to take any other measures required for the achievement of these objectives. ■

Session 3

POLICY INITIATIVES FOR MARGINALIZED SECTORS

Chairperson:	*Kazumi Goto* Managing Director, Research Institute of Development Assistance, Overseas Economic Cooperation Fund, Tokyo, Japan
Introductory statement:	*Kazumi Goto* Research Institute of Development Assistance, Overseas Economic Cooperation Fund, Tokyo, Japan
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Panellist:	*Mitsuhiro Kagami* Director, Research Planning Department, Institute of Developing Economies, Tokyo, Japan
Panellist:	*Soekarno Wirokartono* Deputy Chairman for Fiscal and Monetary Affairs, National Development Planning Agency/Bappenas, Indonesia
Panellist:	*Janet Farooq* Chief, Development Policy Analysis Section, Development Research and Policy Analysis Division, Economic and Social Commission for Asia and the Pacific, Bangkok, Thailand

The "East Asian miracle" as intellectual public property

With special reference to the use of policy-based directed credit to support marginalized sectors

*Kazumi Goto**

Introduction

The post-cold war world is being shaken by two major forces: political democratization and economic liberalization. East Asia, now regarded as the world's growth centre, has achieved rapid economic growth. This reality has sparked a new policy debate over whether development should be led by the government or the market, and specifically concerning the role of the "guiding hand" and the "invisible hand" in development management.

The neoclassical economic view of development aid, which emphasizes the market mechanism, has tended to prevail in this debate. Recently, however, there has been growing interest in the development mechanism (i.e. selective government intervention) that triggered the so-called "East Asian miracle". East Asia's economic success stories show not only the importance of weighing the "three failures" of economic policy management (i.e. the governments, the market, and the coordination of the two) in the light of conditions in each country, but also the need to build strategic management capacity (i.e. adaptability, flexibility and pragmatism) into each country's socio-economic system, as well as the potential to apply the East Asian approach in other regions.

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This situation suggests that development economics may once again become an interesting facet of development studies. How can we go beyond the East Asian miracle? This paper critically examines the lessons of East Asia from the viewpoint of development policies and highlights the importance of forming strategic development management capabilities by asking the following three questions. First, what can we learn from the East Asian miracle? Second, how can we form an institutional basis for shared growth? Third, is policy-based directed credit to marginalized sectors really effective?

1. Lessons from the East Asian miracle

The history of development economics can be divided into a number of major trends, starting with the emergence of the discipline in the 1950s and 1960s. This initial phase was dominated by a structuralist approach that emphasized the role of government in economic development. The "failure of government" triggered a schism into three schools of thought (i.e. the neoclassical approach, reformist approach, which included the basic needs approach, and the dependency or neo-Marxist approach). The 1980s were the heyday of the neoclassical approach, which emphasizes the market mechanism.

In the 1990s, however, changes have started to emerge that may signal a second paradigm shift for development economics. Although this shift does not negate the prevailing trend toward the neoclassical approach, it is significant in the sense that it has led to the emergence of neo-institutional approaches (i.e. the transaction cost approach and the imperfect information approach), the new growth model approach (i.e. the endogenous development theory, the historical chance theory, the big push model), and the capability approach, in addition to the political economic approach to development. Also significant are the intellectual efforts that are being made to go beyond the neoclassical school.

This is leading to renewed recognition of the importance of long-term development strategies rather than just short-term crisis management, and of the role of government in an environment of uncertainty. These shifts in development economics led to the implementation of an epochal study designed to discover the key to East Asia's economic development success. This project resulted from a positive initiative by the Japanese Government (the Ministry of Finance), which has often tended to act as a "sleeping partner" in the area of international development cooperation (especially with regard to policy dialogue and conditionalities in structural adjustment programmes). The research was carried out by the World Bank (1993), which follows a neoclassical approach. It took the form of a comparative study of eight economies: Japan, the "four tigers" (Hong Kong, the Republic of Korea, Singapore and Taiwan Province of China), together with Indonesia, Malaysia and Thailand, which are classified as newly industrializing economies (NIEs). It was published as *The East Asian Miracle: Economic Growth and Public Policy* (EAM). What messages can be read from this study?

Since its publication in the autumn of 1993, the EAM report has attracted considerable interest from officials and researchers in Japan and overseas. Today, not only neoclassical economists but also structuralists and even interventionists are all rushing to cite East Asia's economic success as proof of the validity of their own theories about development strategy. It even seems that the East Asian miracle has become a kind of "intellectual public property" for the world of development studies, including economics.

Another key aspect of the EAM report is its introduction of the concept of the "functional approach" as a more refined version of the "market-friendly approach", which the World Bank advocated in its *World Development Report* of 1991 in preference to the other two schools of thought on the government's role in economic development (the neoclassical school and the state development model). The World Bank's stance on policies "getting fundamentals right" differs from the *laissez-faire* approach of leaving everything to market functions in the sense that, under certain circumstances, it tolerates selective intervention to ensure that the market principle can operate effectively.

However, another characteristic that must be kept in mind in order to understand the nature of the EAM report is the fact that the World Bank does not go so far as to adopt a "revisionist stance" and always seeks to justify this approach within a neoclassical framework. In particular, this is a typical expression of the limited value that the World Bank places on the benefits of "industrial policy" (i.e. government intervention to modify resource distribution for the benefit of specific industries), including policy-based finance.

According to the World Bank's view, therefore, the East Asian miracle can be interpreted as a process that has led to macroeconomic stability and the curbing of inflation, and to the attainment of the three growth functions (accumulation, distribution and productivity improvement) through the successful combination of selective intervention policies relating to the establishment of fundamental conditions. As far as the importance of establishing fundamental conditions is concerned, there is wide support for the World Bank's view. However, the results of a follow-up survey on the East Asian miracle conducted by the OECF Research Institute of Development Assistance (RIDA) show, in the light of subsequent debates in Japan and overseas, that the World Bank's position is contradicted by a wide range of views on the following four aspects.

First, there is the role of government in economic development and the response of the private sector (including the importance of political leadership, development diversity, social mobility and social integration). Second, there is the effectiveness of industrial policy (including policy-based finance). Third, there are institutional aspects of economic development. And, fourth, there is the replicability of the East Asian experience in other regions.

With regard to the policy debate over the role of government and the market in development management, it is particularly important to recognize that neither the free market approach nor the central bureaucratic control approach offers the sole formula for guaranteed growth.

To understand the real issue, it is perhaps necessary to consider what constitutes the optimal level of selective government intervention from the viewpoint of market development, taking into account various factors, including the underdeveloped state of markets in developing countries and the imperfection of information, and giving proper weight not only to the two policy management failures (i.e. the failure of government and the failure of the market), but also to the failure of coordination between the government and the market. In this sense, the East Asian miracle highlights not only the conventional grounds for government intervention (i.e. the failure of the market, justice in distribution, macroeconomic stabilization), but also the need to foster market economies.

In the real world, the achievement of economic development depends not on a choice between a "perfect market" and an "imperfect government", or between an "imperfect market" and a "perfect government", but rather on efforts to discover the optimal combination by treading the narrow path between an "imperfect market" and an "imperfect government". We need to remind ourselves of the importance of recognizing, through the valuable experience of the East Asian miracle, that we can escape from the simplistic "government versus market" dichotomy and discover a wider range of governance formats (including the effectiveness of developmentalist policy structures) for development management.

When considering whether the selective intervention approach, which has been so successful in East Asia, can be applied in other regions, it is basically necessary to create practical development formulae by adopting country-specific approaches through studies that take account of a wide range of factors, including the development state and historical background of each country.

II. Forming an institutional basis for shared growth

In the light of the important lessons taught by the East Asian miracle, let us now consider the issue of "policy initiatives for marginalized sectors", which was one of the main themes of the symposium cohosted by UNCTAD and the Japanese Government (the Ministry of Foreign Affairs) on "The Role of Government in East Asian Economic Development".

The conclusion that emerges from our work in this area is that an approach based on the concept of "marginalized sectors" provides a perspective that is very interesting for the development of debate over the East Asian miracle, in terms of the following four interactions.

First, in terms of the government's role and the response of the private sector, how can the government form a national consensus toward development goals and evoke a positive response from farmers, small business operators and others? Second, in terms of industrial policy, how can small-scale finance and "two-step loans" be used effectively as policy-based financial support tools? Third, in relation to the institutional aspects of economic development, what methods can be used to overcome such problems as transaction costs? Fourth, in terms of applicability to other regions, how should governments approach the endogenous development of systems and the formation of strategic development capabilities?

While these four issues are all interrelated, each may be viewed as an important policy priority in its own right. When undertaking a factor analysis of the East Asian miracle, it is necessary to focus in particular on the institutional aspects of development. We should like to make the following five observations concerning the World Bank's EAM report in relation to the institutional aspects of economic development.

First, the scope of the report's analysis of the institutional aspects of development is inadequate, since it focuses mainly on such aspects as the existence of technocrats, government-private sector harmonization through councils, and income redistribution mechanisms. This is a vital point for debate in the sense that the report fails to deal with the fundamental questions of why East Asian governments were able to achieve greater economic success than the governments of other developing countries through a process of trial and error and adaptation, and why these governments were able to build the ability to form and maintain interactive and effective relationships with the private sector through the efficient use of selective intervention and the flexible adjustment of the content and methods of intervention in response to changing internal and external environments.

Second, in connection with the preceding issue, there is the problem that the scope of the analysis of the World Bank (1993) excludes "institutions" that made an important contribution to economic development in East Asia. For example, the report does not take account of the fact that while East Asian countries have gradually formed basic legal systems and mechanisms (such as property rights and commercial law), which are vital to the efficient operation of a market economy, many developing economies have yet to establish these institutional frameworks. Other aspects excluded from consideration include the processes whereby the East Asian economies have gradually cultivated abilities and institutions that enable them to respond energetically and have aggressively taken advantage of opportunities created by technological innovation.

Third, the potential for the achievement of institutional reform is far greater than envisaged by the World Bank (1993). Instead of merely emphasizing the negative aspects of the existing level of institutional capacity as factors that limit the formulation and implementation of policies, the analysis should have placed greater emphasis on such questions as how institutional capacity can be enhanced through the reform of education or government agencies. One of the important lessons that we can learn from the East Asian experience is that it is by no means impossible to achieve the gradual development of capacity in one's own systems by learning from a variety of experiences, including the creation of various institutions. We need to ask first of all whether or not there is this basic perspective.

Fourth, also significant is the fact that many Asian experts stress the importance of a stable, strong political leadership committed to the national goal of rapid economic development. The common characteristics of political leadership in Asia are: (1) the positioning of economic development as the top priority for political management; and (2) a shared awareness among political institutions of the potential for and effectiveness of achieving long-term improvement in national living standards through the achievement of good economic performance, as a means of gaining recognition of an administration's legitimacy and further strengthening its power base.

Fifth, the economic development of Asian societies seems to have been influenced significantly in the following four areas by social factors, including social fluidity, social unity and the fairness of social structures, which characterize East Asian countries and which have interacted within the processes of economic development:

(i) Development stimulated the emergence of the middle class and enabled more members of society to participate in the development process;

(ii) Development had a limiting effect on social disruption triggered by tension and confrontation;

(iii) Development reduced social demand for income redistribution and weakened the political pressure exerted by interest groups and vested interests on policy makers;

(iv) Development fostered a social milieu in which people were willing to sacrifice the short-term interests of individuals in order to achieve long-term development goals, while helping to form a social environment in which it was easy to share an integrated national vision.

Aspects of the debate over the institutional aspects of the East Asian miracle that relate to the institutional basis for shared growth are thus especially important. The World Bank (1993) places considerable importance on the commitment of East Asian governments to ensure the rapid, widespread sharing of improvements in economic structures as a means of establishing a base for the legitimacy of development policies. The key mechanisms for this purpose are as follows:

(i) wealth distribution plans based on the concept of including non-elite groups in economic growth;

(ii) the existence of economic bureaucracies shielded from narrow political pressures; and

(iii) the existence of organizations and mechanisms that enable the government to share information with and gain the support of private sector elites.

In relation to specific approaches to the achievement of development goals, the World Bank (1993) refers both to education and also development strategies designed to foster agriculture and small business, which form the foundations of society. In relation to agriculture, it ranks government agriculture support measures alongside land reform. As far as small business is concerned, the report recognizes that while growth is generally driven by market forces rather than government intervention, governments in some countries have supported small and medium-sized enterprises (SMEs) by providing preferential finance and establishing special support services. To take this notion further, it would be reasonable to conclude that another characteristic of the East Asian miracle is the fact that although governments have pursued export-oriented growth strategies, they have positively incorporated agriculture and small business into their development policies, instead of marginalizing such sectors.

The RIDA has conducted corroborative studies relating to Thailand and the Republic of Korea in response to the issues raised in the World Bank report in relation to "institutional measures to ensure the sharing of growth" as they pertain to agriculture and the small business sector. These studies show that the promotion of the small business sector has been emphasized during Thailand's economic development as a means of creating employment opportunities, ensuring the effective utilization of domestic resources and alleviating regional imbalances. Other findings include the fact that agricultural finance has played an important role in agriculture, which is a key industry in Thailand. The studies also showed that the *sae-maul* movement in the Republic of Korea contributed to the achievement of social cohesion, which is a prerequisite for growth, through such processes as the reduction of income gaps between the urban and rural sectors.

Numerous Japanese and foreign experts have offered comments on OECF surveys and research, including the aforementioned studies. For example, as observed by Professor P. Mosley of the University of Reading (then the University of Manchester), who is critical of the World Bank's structural adjustment policies, the World Bank (1993) fails to recognize the role of government intervention in the alleviation of income gaps in East Asian countries (including the effectiveness policy-based finance for small farmers and SMEs).

On the other hand, the importance of an institutional basis for shared growth appears to have been verified to a considerable extent by Japan's own experience of economic development in the post-war period. It is important to recognize at least the following three aspects of the measures targeted toward agriculture and the small sector as part of the various reforms implemented in post-war reform.

First, rural land reform raised the motivation to produce by enabling farmers to own land. This encouraged farmers to save more, thereby contributing to the provision of funds for agricultural investment. The uptrend in farm incomes, which increased 1.8 times in the five years between 1960 and 1965, for example, helped to expand domestic markets, while rising productivity provided a source of labour for the industrial sector.

Second, while implementing economic democratization measures, including the dissolution of the *zaibatsu* (conglomerates), the avoidance of concentrations of economic power and the establishment of the Antimonopoly Law, the government also introduced systems to foster SMEs. Initially the government took a passive and protective stance in its small business policy, the aim of which was to protect SMEs as the weaker members of the business sector. From the late 1950s onwards, however, technological progress was parallelled by a shift in emphasis toward the provision of support for facility modernization and rationalization. As a result of this small business support policy, Japan began to move during the 1960s towards the elimination of its wage gap (dual structure) through the achievement of full employment and the emergence of a labour shortage. This played a key role in the expansion of domestic markets.

Third, financial assistance was a key element of support for agriculture and small business. In the agricultural sector. Credit was provided through agricultural cooperatives and government financial institutions (such as the Central Bank for Agriculture and Forestry). The People's Finance Corporation (1949) and the Japan Finance Corporation for Small Business (1953) were established with government funding to assist SMEs). The fiscal loan and investment system functioned effectively in this context and played an important role.

In order to gain a clearer overall picture of the dynamic development process as a means of verifying the applicability of the East Asian experience to other regions, it will be necessary to examine, verify and enhance the methodology used in "comparative studies of institutions". The most important perspective in this context is to approach development as a dynamic process of transition through structural change from a traditional exchange economy to a modern market economy. However, this work cannot be achieved solely through economic studies, since it also involves major issues relating to "structural transformation" (i.e. social change) affecting society as a whole. "Development issues" must be understood in terms of how flexible, competent and effective institutions can be created within the relevant social systems in order to allow these structural changes to occur.

If this view is correct, it is impossible to identify the dynamic processes of development without a comprehensive examination of the political, economic, social and cultural factors that make up the various institutions. In this sense, the most important tasks now are to create a "systems approach" that integrates the "institutional approach" and the "policy approach", and to conduct comparative study based on this approach.

We are thus seeking a new frontier in development studies, one that will take us beyond traditional economics and enable us to conduct comprehensive studies of the role of development policy in relation to government and the markets in developing countries. We see the East Asian miracle as a "knowledge treasure-house of information" that will revitalize development economics.

III. Using Japanese ODA financial cooperation to provide policy-based directed credit to marginalized sectors

As part of Japan's official development assistance (ODA), OECF provides policy-based directed credit aimed at nurturing agriculture and SMEs, as well as low-interest, long-term direct loans intended for the construction of economic and social infrastructure by developing governments.

Policy-based directed credit-type loans ("two-step loans" or TSLs) amounted to 561.6 billion yen, approximately 4 per cent of the approved cumulative total of 14,181.2 billion yen at the end of December 1995. These loans have been provided, for example, to the Republic of Korea (for the promotion of agriculture and SMEs), Thailand (agriculture and SMEs), Indonesia (SMEs), Malaysia (SMEs), India (small business), Bangladesh (agriculture and agricultural cooperatives), and Brazil (agriculture).

We shall review three examples from the perspective of the institutional basis for shared growth, which has been discussed in the previous chapter. They are as follows:

(i) the Small Industries Development Bank of India (SIDBI) as an example of generating visible benefits;

(ii) the Bank for Agriculture and Agricultural Cooperatives (BAAC) of Thailand as an example of participatory development; and

(iii) the Grameen Bank of Bangladesh as an example of endogenous development.

A. Small Industries Development Bank of India (SIDBI) as an example of generating visible benefits

In India, TSLs have been provided through the SIDBI five times since 1988 to small industries for use as long-term investment funds. The loans amounted to approximately 99.7 billion yen at the end of December 1995. The basic loan scheme comprises two steps. First, funds borrowed by the central government are lent out to the SIDBI, which sub-lends the funds to "primary lenders", such as state financing corporations and scheduled commercial banks. Second, actual lending to small enterprises is undertaken by the primary lenders, which, after lending out, receive loans from the SIDBI through reimbursement under a system known as "refinancing".

Surveys of the first through third loans have yielded the following findings:

(i) Of the first target group in the third loan programme, 11,141 sub-projects in operation have employed a total of more than 251,000 workers. As 70 per cent of investment is targeted for the establishment of new enterprises, this employment figure can be regarded as reflecting the incremental effect of the scheme.

(ii) It is difficult to carry out a comparative analysis of values added owing to the unavailability of statistical data for the entire Indian small business sector. However, the fact that the 11,141 sub-projects created added value worth Rs 24.6 billion in fiscal 1991/92 (around 120 billion yen compared with total loans of 20.3 billion yen) suggests that the scheme has contributed to the expansion of industrial production as a whole.

(iii) A total of 463 loan-targeted sub-projects have been exporting their products, which amounted to Rs 3.2 billion in fiscal 1991/92 (around US$ 100 million, 0.5 per cent of India's total exports of US$ 20 billion in that year).

Obviously, the scheme has produced reasonable "visible" benefits given the scale of the Indian economy, although some problems still remain to be solved. The first problem concerns the maintenance of the scheme's conformity with financial sector reforms. In India institutional finance both in the small business sector and in other sectors is supported by regulations concerning obligatory finance directed towards priority sectors, as well as by the high-rate cash reserve regulations applied to commercial financial institutions in order to secure sources of funds (it is permitted to include bonds held by government financial institutions, such as the SIDBI, when calculating the reserve ratio). However, this practice is regarded as thwarting the management autonomy of commercial financial institutions and has been criticized, together with the fiscal deficit, for causing a crowding-out effect. It is now targeted for reform. These regulations are presumed to be an alternative institutional arrangement to a Japanese-style fiscal investment and loan system. This presumption suggests the possibility of creating an institutional mechanism for mobilizing small-lot savings against the background of relatively high savings rates.

The second problem is the rate of arrears at the end-user level. Although there have been some improvements over a long period, some primary lenders still have more than 30 per cent of their loans in arrears, with a major portion regarded as "wilful defaulters". This poses the problem of overcoming asymmetry of information at the end-user levels.

Despite these problems, small-business loans made possible by TSLs are helping to create employment in modern sectors, and thus deserve credit, together with the government's implementation of economic reforms, for helping to form the basis for shared growth in the face of social conflict among different classes and communal.

B. Bank for Agriculture and Agricultural Cooperatives (BAAC) of Thailand as an example of participatory development

Since 1975, a total of 56.2 billion yen for 14 projects has been provided to the Bank for Agriculture and Agricultural Cooperatives (BAAC), which was reorganized into its present form in 1966 from its predecessor, the Cooperatives Bank, which was established in 1947. The reasons for this amount of loans are twofold. The first was the constraints resulting from the low organization rate of credit cooperatives, for which cooperative bank loans were intended, including the difficulty of securing fund sources and limitations on loan targets. The second was the worsening debt problem of farmers, who had a growing demand for funds but were suffering from a reduced flow of loans from commercial banks and had to resort to flexible informal lenders, even at annual interest rates of 30 to 50 per cent. Assistance to the BAAC by means of TSLs has played a major role in reducing lending costs by breaking the monopoly of informal lenders and coping with asymmetry in information through the function of group financing, which will be discussed later. This view is not unopposed. For instance, Siamwalla *et al.* (1990, pp. 271-295) express certain reservations about the role played by the BAAC by reminding us of the following two points:

(i) the high lending rates asked by informal lenders reflect information costs, and not the scarcity of funds (indeed, interest rates in the informal financial markets have remained almost unchanged for more than 20 years); there is also competition among lenders;

(ii) the formal financial sector, including the BAAC, does not play an adequate role, particularly in providing operating funds, while the informal financial sector continues to play a major part in this respect.

Despite these problems, however, the BAAC's role should be appraised not in terms of spot short-term credit accommodation but as having provided farmers with services usually unavailable in the informal markets, i.e. long-term loans, and for those who have achieved a certain level of performance. "Credit allocation loans" are available in a timely manner. (Incidentally, yen credit is provided for long-term loans.)

The benefits of the BAAC's own joint liability loan scheme are broadly acknowledged. This scheme is based on a joint liability lending system, under which loans are provided under the mutual joint liability of groups of farmers (14 on average) selected and organized by the farmers themselves. This scheme has been highly successful, and the recovery rate for the first to the seventh loans provided by OECF is estimated at over 96 per cent. Siamwalla *et al.* (1990) also expect the final bad debt ratio to be less than 3 per cent of the BAAC's total loans. This low level ratio is due to a mechanism called "group financing" or "peer monitoring", and the cost reduction effect achieved through this function deserves close study. A similar system is employed in many cases, as typified by the Grameen Bank of Bangladesh.

However, the introduction of such a mechanism must be preceded by careful study of award and punishment systems and related social institutions. Unless such institutions are properly designed, there is a risk that such a mechanism will lead to concerted defaults. To cope with such defaults, the BAAC employs the following steps, while reducing the lender's transaction costs through voluntary controls, especially by group leaders. First, over 4,000 employees from its 600 branches and more throughout the country make daily contacts with farmers to monitor the conditions of their families, production, assets and the progress of credit-targeted projects. Second, farmers are under pressure to make timely repayment because of their perception of the BAAC loans as a permanent scheme, and their awareness of the fact that arrears would result in higher interest rates and disqualify them from receiving new loans. These mechanisms should guarantee the system's effectiveness.

C. *The Grameen Bank of Bangladesh as an example of endogenous development*

The OECF's extension of credit accommodation to the Grameen Bank in 1955 has been reported extensively as a sign of a major step towards the provision of direct assistance to the poor and needy by the OECF. We will comment briefly on this scheme.

Grameen Bank's loan programmes have certain characteristics. First, loans are available only to the landless poor, whose actual area under tillage is less than 0.5 acres (20 *ares*). Under the group loan system, groups made up of five farmers of the same sex from the same social environment are provided with loans that they promise to repay as a joint responsibility. Second, although there are no sexual discrimination clauses, women account for 94 per cent of all borrowers, making the programmes worthy of recognition from the viewpoint of "women in development". The development impact of the Grameen Bank has been acknowledged by many empirical studies as having: (1) improved living standards through increased income; (2) enhanced women's independence and participation in social activities; and (3) increased employment opportunities.

The Grameen Bank ensures a very high repayment rate of 98 per cent thanks to its group loan mechanism. This performance results from a well-organized, one-week training scheme for borrower groups, who are instilled with respect for the rules, and from the bank's grass-root monitoring of borrowers. More than 10,000 bicycle-equipped bank employees make the rounds of group members and customers, providing many advisory services. In addition to strict monitoring of repayment and recovery, rewards for punctual repayment (a higher loan ceiling) and penalties for arrears (suspension of loans) are effectively implemented.

The Grameen Bank's programmes are drawing international attention. The introduction of similar rural finance schemes has become a focus of development programmes. This factor may cause a stir in discussions about the replicability of the scheme. The idea of overcoming the problem of transaction costs through human relations does not seem to be too far from monitoring mechanisms based on relatives, acquaintances and business connections in the fragmented markets of traditional rural villages. More important, it seems to highlight the importance of forming strategic development management capabilities in the process of sublimating informal traditional practices into a modern formal system (that is, a certain level of endogenous institutional development and supporting development management mechanisms) in order to improve productivity and promote economic growth through access to funds.

There have been many theoretical and practical discussions, including the aforementioned reviews, about the need for and effectiveness of policy-based directed credit and institutional credit in the economic and social development policies of developing nations. There is also a considerable accumulation of empirical studies.

Discussions have tended to focus on whether interest rates offered to end-users should be preferential or market rates. In the process, there have been occasional misunderstandings in which one side, such as the OECF, insisted that the greater the degree of preferential treatment the better, while the other side, such as the World Bank, argued that interest rates should be the same as market rates. At times it seems that discussions have tended to end up in speculative arguments, while pushing aside the circumstances and diversities specific to the developing nations, which differ from those of developed nations.

The World Bank (1993) finally, albeit hesitantly, recognized the value of policy-based directed credit by stating that in some East Asian countries these programmes have caused less damage to capital allocation and may have been beneficial. This statement, however, can be interpreted in two ways. Some argue that it means that a certain degree of recognition has been gained concerning the role of policy-directed credit in the development policy of developing nations. Others contend that the effectiveness of credit is significant only in specific East Asian countries, including Japan, and that the experience of those countries cannot serve as a model for other countries and regions that lack the necessary capabilities. An effort to reconcile these two interpretations of the effectiveness of policy-based directed credit would be very meaningful in terms of considering the replicability of the East Asian experience in other regions from the perspective of a comparative analysis of institutions and from the viewpoint of development policy.

IV. Evaluating the effectiveness of policy-based directed credit to marginalized sectors

Based on the foregoing perception of the problems, we now focus on practical prescriptions leading to successful policy-based directed credit. Our review starts with a definition of "policy-based directed credit". Which is one of the OECF's assistance objectives and is defined as a system for providing specific end-users with medium- and long-term credit, mainly through banking mechanisms, under more favourable terms and conditions than are available in the market or commercially. It is intended as a means for developing governments to implement their specific policies.

Why then is policy-based directed credit necessary? Essentially, it is desirable for the financial market to achieve the effective allocation of resources not through government policy intervention, but through interest rates determined by equilibrium. In reality, however, market failures, which depend on the development state of the country in question, can occur even in the financial market owing to such causes as: (1) imperfect information (asymmetry of information); (2) external effects (external economies and diseconomies); and (3) insufficient competition (monopolies). The government, for its part, should respond not only to these market limitations in the narrow sense, but also to those broadly defined limitations that cannot always be overcome by means of Pareto Optimum (equity of income distribution, sustainability of future economic growth, etc.) and concurrently pursue objectives beyond the efficiency of resource allocation.

Policy-based directed credit, along with credit allocations and various regulations (and deregulations), is used as a policy measure for government intervention to cope with the above limitations of the financial market. But if a market failure is used as the reason for government intervention, the cause of the failure and its specific details must be fully examined.

Target projects for policy-based directed credit include those listed below, which are based on the aforementioned model of "specific governmental policies". Projects designed to cope with imperfect information in financial markets include those designed to foster SMEs, encourage rural development, and promote agriculture and fisheries. Projects intended to respond to external effects include those for the prevention of pollution, protection of the environment, and promotion of agriculture and fisheries. Projects designed to ensure equity of income distribution include those for fostering SMEs, enhancing rural development, promoting agriculture and fisheries and eliminating poverty. Projects relating to sustained economic growth include those designed to foster SMEs, promote exports, protect the environment, encourage rural development, eliminate poverty and develop technology.

Such financial assistance is also significant because it directly supports end-users' business activities. Modern credit markets have not yet been developed either in the agricultural sector or the small business sector of developing countries. The consequent heavy reliance on informal (non-institutional) credit markets poses an impediment to their development. The reasons for this are often ascribed to: (1) distortions in supply and demand caused by oligopolistic (monopolistic) financial structures; (2) asymmetry of information (lack of information for borrowers) and transaction costs; (3) investment as an external economy; and (4) the lack of source funds.

In order to overcome constraints and credit conditions on access to funds, which comprise a major bottleneck in development, it is important to provide end-users with a certain level of small-scale credit as a direct assistance tool (as part of policy-based directed credit).

Of these types of small-scale credit, rural credit has aroused awareness of problems that have existed since the 1980s, including: (1) low loan recovery rates; (2) the problem of transaction costs; (3) aggravation of rent-seeking activities; and (4) higher reliance on external funds. Despite these problems, however, many small-scale credit programmes provided by the OECF to the agricultural and small business sectors through policy-based directed credit have been operated successfully for many years. Through these schemes, credit is gradually having a positive effect.

How can policy-based directed credit to support marginalized sectors be used effectively? We shall review effective measures from four perspectives in the light of the OECF's past experiences with: (1) The effectiveness of policy-based directed credit; (2) the policy characteristics of such credit; (3) policy-based directed credit and the development of the financial market as a whole; and (4) the management of policy-based directed credit on market principles.

The effectiveness of policy-based directed credit should be discussed with the following two points in mind. First, since policy-based directed credit is introduced to achieve future policy objectives, these objectives must be realized together with other policy measures that are implemented concurrently. Second, policy-based directed credit must be introduced in such a way as to direct a country's financial market towards healthier development based on market principles (including the liberalization and internationalization of financial markets in developing countries) and to contribute to the resulting effective allocation of resources (or at least not to disrupt effective resource allocation).

These two perspectives should be addressed further: the former as a problem of the achievement of policy objectives of policy-based directed credit; the latter as a problem relating to policy-based directed credit and development of the financial market as a whole, and the management of policy-based directed credit under market principles.

The achievement of the policy objectives of policy-based directed credit hinges on five factors: (1) The adequacy and suitability of policies as the prerequisite of policy-based directed credit must be ensured. (2) Multiple policy measures for achieving the above-mentioned policies must be fully examined and prioritized as to their pros and cons, taking into consideration the limited financial and human resources. The policy-based directed credit in question should then be selected as being essential and indispensable, and both the policy-based directed credit and other policy measures adopted after a comparison of their relative merits should be in a mutually complementary relationship and should jointly contribute to the achievement of policies. A typical example is a combination of policy-based directed credit with technical assistance, infrastructure construction and farm land reforms. (3) The achievement of policy goals should be regularly monitored by quantitative cost-performance indices and evaluated after a certain period of time. Depending on the results, the policy itself, as well as policy measures that have been expected to contribute to its achievement (especially the policy-based directed credit in question), should be flexibly reviewed and modified (or discontinued). (4) The funds provided to end-users through the policy-based directed credit should be used efficiently and effectively. Investment in the sectors (including subsectors), regions or policy areas targeted by the policy credit should increase or accelerate, compared to a situation where no such credit is provided (investment-increasing effect). (5) In order to ensure the preceding four points, governmental agencies (ministries of agriculture, trade, etc.) in each developing country, as well as the public or private intermediary financial institutions that implement policy-based directed credit, and the supervisory agencies (ministry of finance or treasury) in charge of financial sector development should establish a mechanism that ensures appropriate coordination (including adjustment among sectors) and mutual support in policy planning, implementation, assessment and modification.

The relationship between policy-based directed credit and the development of the financial market as a whole depends on the following three factors: (1) Existing financial markets in developing countries should be fostered, subject to such requirements as the prevention of capital flight and promotion of domestic savings, and against a backdrop of keener international competition for extremely speedy adjustment. Apart from the question of scale, policy-based directed credit as well as its size should therefore be flexibly modified in accordance with the developmental state of each country (particularly the developmental stage of its financial markets). Financial markets should in this way work to graduate from governmental funds to private funds. (2) The interest subsidy provided through policy-based directed credit intended for end-users should be the minimum required to provide end-users with an incentive. (3) Policy-based directed credit should not replace or "crowd out" investment by private funds. Rather, it should supplement the shortage of private funds.

As a prerequisite for the above-mentioned three factors, the government of a developing country should establish legal, policy and institutional frameworks designed to create an efficient and safe financial market. The management of policy-based directed credit under market principles is contingent on the following three factors: (1) The selection of end-users and target projects for financing (or decisions about resource allocation through policy-based directed credit) should be free from arbitrariness and political influence, and should be effected in line with the policy on which the policy credit is based, and in conformity with rules previously established on the basis of economic rationality (that is, fairness and neutrality). Only then can rent-seeking activities and corruption be prevented. Indispensable for this purpose are (a) an assessment by intermediary financial institutions, based on the characteristics of policy goals and final end-users targeted by the policy, and (b) the establishment of a system to safeguard claims and support these efforts. (2) It is important to establish a system (including external assistance) for monitoring and assessing as well as for the appropriate screening of end-users and subprojects, in order to improve investment efficiency at the end-user level and realize a high recovery rate, while contributing to the realization of specific policies. (3) It is necessary to provide intermediary financial institutions involved in policy-based directed credit with a reasonable spread and to secure their financial health by introducing low interest funds from outside sources, including the OECF, in addition to funds raised from the private sector. At the same time, care should be taken to keep the spread from expanding excessively in order to ensure the efficient use of funds and prevent harmful practices, such as monopolies and unsound management.

Finally, to ensure the success of these three factors, government agencies must provide appropriate support, such as the securing of funds (including government funds), fund procurement (including borrowing from outside sources and government guarantees), and the absorption of exchange risks by the government. Supervision by these agencies (with auditing by a neutral third party, in some cases) may be necessary. However, the scope and extent of supervision and regulations should be limited to the absolute minimum needed to avoid moral hazards without compromising the managerial autonomy of the intermediary financial institutions, and to avoid an excessive government burden resulting from excessive intervention.

We have reviewed in general terms the many conditions required for successful policy-based directed credit, as well as related problems in the light of the OECF's experience. The conditions we have mentioned are all closely related, and the extent to which they are satisfied varies with the country, sector and period.

Policy-based directed credit is applied at the interface of contact between macro- and microeconomics, between the financial sector and the policy-target sectors, between the government and the private sector, between efficiency and equity, between economic and social developments, and between monetary and fiscal policies. If the conditions for the efficient and effective management of a policy-based directed credit system are in place, the way will be paved for the applicability of the system to regions other than East Asia.

V. Conclusion: forming strategic development management capability

We shall conclude this discussion by considering how we may go beyond the East Asian miracle. It may be difficult to draw general lessons concerning development policy management because development policies and experience over the past 40 years differ widely with the country and period. Nevertheless, it is important to point out, from a broader perspective, at least the following four practical lessons that may be gained from the past handling of development policy management.

First, in relation to development plans, the appropriate combination of the following three factors is a condition for promoting sustained economic growth: (1) stable macroeconomic management; (2) market prices, including interest rates, centred on economic and industrial policies that fully utilize incentive systems; and (3) establishment of physical and institutional infrastructures and human resources.

Second, in relation to development models, it is necessary to select a combination of models appropriate to the economic and social systems and history of each country with differing levels and phases of development, including the coordination of comprehensive model approaches and micro-level model analysis.

Third, in relation to development assistance strategies (particularly structural adjustment programmes), it is essential to ensure the effectiveness of policy dialogue and conditionalities by continuously assessing economic rationality and the political and social costs in the hope of continuously reforming policies.

In addition, to ensure the adequacy of the policy package to respond to the actual circumstances of the countries concerned, adjustment programmes which include institutional reforms should be integrated by stages as part of medium- to long-term development plans.

Fourth, in relation to the aid approach to development management, it is important that development management be considered not only from the viewpoint of administrative improvements through institutional and organizational development within the public sector but also from the practical use of the market mechanism and managerial improvements in the private sector.

In addition to these four practical lessons, a more important one would be the need to form the "strategic management capability" to make choices from diverse and complex options concerning development policies in the course of seeking organic cooperation between the government and market in both areas of domestic and international systems. The importance of this lesson is demonstrated by the experiences of economies that have developed successfully, including East Asian ones. The capability is twofold: the ability to learn from practice, and the ability to modify policies if necessary. Because of this capability the system in question incorporates three elements: *adaptability, flexibility* and *pragmatism*.

In the world of development, the employment of proper policies is less important than the construction of economic and social systems that enable a nation to recognize and adopt such policies at their own discretion. Without such internal efforts, a country cannot be expected to achieve development, and assistance from the aid-providing side is unlikely to yield the desired effect.

The early structuralists committed the error of regarding this capability of the economic and social systems as given. They assumed that the government already had the capability of managing its intervention. Considering the after-effects of unsuccessful intervention in the 1960s and the 1970s, this assumption seems to have impaired confidence in their research achievements. These after-effects, however, have helped to revive neoclassicism, which has posed two problems. First, despite many failures by the government, public organizations are still expected to be directly involved in the improvement of the social and physical infrastructure in developing countries. The market, which cannot alleviate poverty, does not supply the public goods on which the private market depends. The government plays a major role in this regard. What is more, strategic intervention is a prime mover for growth and development, as demonstrated by the experiences of East Asian countries. Second, neoclassical theory does not adequately meet the needs of less developed economies. As they admit, it seems that neoclassical economists are unable to give a convincing explanation of the process of development and its dynamic aspects. They suggest "getting prices right" but fail to identify the necessary and sufficient conditions for appropriate prices. Such an approach would replace *factual truth*, which forms the ultimate end as well as the basis for explanation and prediction, with *analytic truth*.

Awareness of these problems leads to the realization that it will be necessary to develop analytical models that may be used to explain how the development process can be controlled and managed. It also suggests the need to redefine development from this viewpoint in terms of whether it means growth, elimination of poverty or structural transformation. A commonly observed characteristic in the process of the shift from a traditional exchange economy to a modern market economy is the structural transformation of nations. The problems related to development in this process should be viewed as problems of the creation of, or transformation into, flexible, useful and practically effective economic and social systems.

The problem of the replicability of the experiences evidenced in the East Asian miracle in other regions should be discussed not for the purpose of recommending the employment of similar policies, but for the purpose of learning practical methodologies for the development of the capabilities needed for dynamic economic and social systems that can adapt to constantly changing world markets and seize opportunities.

The World Bank (1993) fails to show a sufficient and deep understanding of many institutional aspects. The major reason is the lack of distinction between policies and economic and social systems, in addition to a bias toward free market principles. As we have agreed, at the root of discussions about development management in the developing nations is the belief that development must be autonomous.

Lastly, we should like to emphasize that East Asian countries differ from other developing economies in that they have made effective and discretionary use of comprehensive economic cooperation (i.e. aid, investment and trade) from Japan and other countries out of their longing for growth and equity, and that they have established many institutions and fostered the above-mentioned management capabilities through their own sustainable development efforts. Without such self-help efforts, assistance from any foreign country or international organization is unlikely to yield sufficient benefits. Without a firm will to develop itself, no country can be constructively helped in its efforts to develop the capabilities to realize its development.

The formation of strategic development management capability, which consists of the theory and practice that enable developing countries to implement reforms of their economic and social systems in order to achieve autonomous development, is a frontier that will require intellectual effort in terms of development assistance policies dealing with the interactions between development and assistance, and also in terms of new work in the fields of development studies, including development economics. ■

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Comments

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I read the paper of Mr. Goto *et al.* (1996) on the East Asian miracle with great interest. The paper focuses on what Mr. Goto describes as "policy-based directed credit to support marginalized sectors", and it describes several issues which have been of direct concern to my own bank, the Bank for Agriculture and Agricultural Co-operatives (BAAC).

First of all, I should like to elaborate a little on the BAAC's history and development. In particular, I wish to stress the delicate balancing act that we, as its managers, have to perform between what Mr. Goto calls the "invisible hand" of the financial markets, and the "guiding hand" of government intervention. In other words, how can we assist the marginalized farmers of our country while at the same time respecting the realities of the financial market place? How can we ensure that our farmers have a reasonable chance of sharing in our country's overall economic growth without turning both them and ourselves into uncompetitive dinosaurs, unable to adapt to the modern world? Moreover, how can we ensure that the "guiding hand" of a democratic, populist government fully reflects the country's long-term interests and the wisdom and experience that can be gained from comparable situations around the world, rather than only short-term political considerations?

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Bearing these questions in mind, the history of the BAAC may be summarized as follows. The bank was established in its present form in 1966. It is a state enterprise bank under the control of the Ministry of Finance, with a mandate to lend to both individual farmers and former institutions (cooperatives and farmer associations). In its early years the BAAC was a rather small organization with relatively few branches and limited funds so that it could make little impact on financial markets. Farmers depended for finance almost solely on local private moneylenders who charged very high rates of interest, often well above 30 per cent or even up to 50 per cent per year, as Mr. Goto mentions in his paper.

In 1975 a new democratically elected government came to power in Thailand, with a strong commitment to promoting rural development. At that time the commercial banks lent less than 2 per cent of their portfolio to the agriculture sector. Viewing that this was not enough, the government said that the share should be at least 5 per cent, and if the banks could not find enough clients of their own, they should deposit the leftover with the BAAC. Over the next few years, that 5 per cent share was raised steadily to 14 per cent for agriculture and a further 6 per cent for other rural enterprises. The commercial banks never fully met these targets, but their mandatory deposits gave a big boost to the BAAC, whose network expanded from a handful of branches near Bangkok to 365 branches throughout the country, for over 4 million registered clients, i.e. 80 per cent of Thailand's farm households, with outstanding loans worth over US$ 4 billion by 31 March 1995.

With such a history, it is clear that the BAAC has served as the country's main channel for policy-based directed credit to farmers, and has been the main institutional beneficiary of that policy. But neither the BAAC management nor successive governments were content to remain dependent on this kind of policy, or on funds from the public sector only. The BAAC has steadily expanded its sources of funds, and placed progressively greater emphasis on mobilizing rural savings, thereby further boosting and diversifying its loan operating fund. The BAAC has reached the point where "deposits from the public" make up the largest single source of the operating fund, now accounting for a little over 50 per cent, while mandatory deposits from commercial banks make up less than 6 per cent of the operating fund.

Reflecting a genuine effort by the BAAC to attract savings, this change, while virtuous, is not quite a free-market triumph. It is because even here the government's "guiding hand" is not totally out of sight. "The public" includes some government organizations, such as the Ministry of Finance, which "encourage" to store their funds in the BAAC, and they account for almost half of all "public" deposits. Nevertheless, things have moved a long way towards what Mr. Goto describes as graduating from public to private funds.

In view of this transition, the BAAC has been widely praised for making a good start at escaping from its "directed credit" roots. The World Bank included the BAAC as one of four examples of successful rural banks in a recent study; and according to calculations based on FY 1994 data the level of "subsidy dependence"[1] had fallen almost to nil. The BAAC has been selected as one of the first batch of profit-making state enterprises in Thailand to enter a World Bank-supported scheme to relax certain government regulations, for example those covering staff pay scales, in return for reaching various commercial and other performance targets. We anticipate that this programme will have a significant effect on the bank's future direction.

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[1] Briefly, the "subsidy dependence index" developed by the World Bank measures the difference between present interest rates and the rates that would have to be charged if all subsidies were withdrawn.

However, the supporters of continued and even increased levels of subsidy, and of a disregard for market realities, have not disappeared or given up on attempting to re-direct the BAAC's development. The bank's lending interest rates have been their main focus of attention. From the start, lending interest rates have presented a problem for the bank's management. To simplify, the government has required the bank to charge farmers at rates a few points below local commercial rates, to lower its administration costs, and to find enough money from concessional sources to keep down the average cost of funds and thereby make a small profit. This we have done. Administration costs now amount to only about 3.8 per cent of the value of outstanding loans, on-time loan recovery rates have increased to about 89 per cent and bad debts make up only a tiny proportion of our portfolio. As Mr. Goto mentions, the OECF has been the largest single source of concessional funding to the BAAC. In addition, the BAAC has also borrowed from the World Bank, IFAD, the ADB, KFW and others, and has benefited from two grants from the European Commission.

The BAAC management's ability to carry out this balancing act has brought applause from everyone. Almost everyone. There have always been people in the Ministry of Agriculture and elsewhere claiming that the BAAC's interest rates are too high for small farmers, especially when small farmers want to make long-term investments. As the result of pressures from various quarters, the original relatively straightforward interest rate policy has gradually unravelled, notably (but not only) because of the government's introduction of large-scale rural development programmes in 1992, with low-interest loans as their centre-piece.

Under these programmes, the government provides the loanable money, and the BAAC administers the loans in return for a fee paid by government. Farmers pay 5 per cent, about half the BAAC's normal rates and slightly below the current consumer price inflation rate. By comparison, the commercial banks' prime lending rate is 13.75 per cent, and farmers who borrow from commercial banks would be expected to pay about 15 per cent. The government's special credit programmes have grown steadily, though they are still relatively small compared to all BAAC loans. Arguably they have not harmed the BAAC directly because its money was not involved, though the programmes have certainly been a serious distraction from time to time for both the management and the field staff. But there is no doubt that the availability of loans at 5 per cent has created a general climate of expectation which has put pressure on the bank to lower its own rates.

Pressure to lower interest rates comes from many directions, including directly from farmers in the form of protest marches and demonstrations, which might be spontaneous but might also be planned with political goals in mind. During the last few months there have been decisions from within the government that the BAAC should reduce its "normal" interest rate from 11.25 per cent to 9 per cent on all loans worth not more than 30,000 baht (US$ 1,200), which make up about 20 per cent of the value of all BAAC loans. There is no announced plan to change interest charges for larger loans.

The effects of such policies on the BAAC's viability are not difficult to imagine. According to the annual report published on 31 March 1995 (i.e. before the recent changes came into effect), interest earnings averaged approximately 9.5 per cent of the average value of loans outstanding, with a further 1.5 per cent earned from other sources; the cost of funds was 6.5 per cent and administration costs were 3.5 per cent, leaving a profit of about 1 per cent. With such slender profit margins, an interest rate reduction of two percentage points on 20 per cent of all loans would leave the bank in a vulnerable position.

Moreover, as managers we have to consider such essential issues as staff morale. As Mr. Goto points out in his paper, the

BAAC's relatively good field performance depends on close relationships between our hard-pressed field staff and our borrowers. We have been able to maintain relatively high levels of morale and good field performance by creating relatively good working conditions, including some incentive payments for achievements judged in accordance with known criteria. But these are mainly, and in my view rightly, business criteria, including profitability. To put it simply, falling loan interest rates mean falling (or even vanishing) profits, and falling profits carry a high risk of leading to lesser pay and worsened working conditions; the situation would eventually lower staff morale, with all its attendant dangers.

In conclusion, I would like to return to my original questions: how can we assist the marginalized farmers of our country while at the same time respecting the realities of the financial market place? How can we ensure that our farmers have a reasonable chance of sharing in our country's overall economic growth without turning both them and ourselves into uncompetitive dinosaurs, unable to adapt to the modern world?

As one of the main results of policy-based directed credit, the BAAC has, in my view, played an important role in addressing these questions. Most importantly, the bank has grown to the point where an extensive and almost complete network is in place for efficiently and inexpensively providing financial services to the country's farmers, a network that would not have existed without some kind of "guiding hand" from the government. So we might judge past "guiding hand" policies for directed credit as basically correct in these respects. But are they also the policies of the future?

I have serious doubts as to whether either the BAAC as a bank or our farmer clients would benefit in the long run from a policy of continued or increased subsidy and governmental guidance, unless that guidance fully respects the international economic realities of the 1990s and beyond. We can no longer consider financial policies in isolation. Our country's commitments under GATT and the World Trade Organization alone require us to limit and eventually reduce our subsidies to our farmers. Since the government has independently committed itself to "liberalizing" Thailand's financial sector, it is hard to see how the BAAC can be excluded for long from the liberalization process. Most importantly, we must recognize that if our farm sector has been "marginalized" and requires restructuring (which many of us believe it does), then policies to facilitate this restructuring must include many components of which credit is only one, and probably a relatively minor one. ■

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Comments

Mitsuhiro Kagami[*]

I. Introduction

The performance of the East Asian economies has caught the eye of policy makers as well as development economists. Many think that there is a hidden secret to the region's good performance, particularly in terms of growth. Discussions have now reached the point where industrial policy and institutional arrangements are viewed as the key issues in the rapid development of the region. It is, however, very difficult to promote such interventionistic approaches to other developing countries during the 1990s, when a *laissez-faire* paradigm is predominant and trade liberalization under the WTO is proceeding strongly.

Under these circumstances, explanations for the East Asian region's high marks need to be persuasive, both theoretically and pragmatically. Good outcomes do not directly imply the result of good policies or well-organized institutions. Here, clear logic and a deep insight into the relationships between markets and government are needed.

There are several forms of markets - from perfect competition to complete market failure. There are also several varieties of economic agents from pure private firms to 100 per cent state-owned enterprises. The price mechanism has different facets such as perfect, imperfect, administered and monopolistic prices, according to the nature of the market. Similarly, economic agents have several combinations according to the state of government-business relations. Therefore, a set of options can be selected according to the degree of government intervention between markets and agents: from one extreme (a communist-type state control economy) to the other (a Walrasian market economy). The kind of set chosen depends on a country's intrinsic political and economic values and its history.

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Latecomer countries in development tended to foster private domestic companies, as opposed to transnational corporations (TNCs) under an import-substitution framework. Faulty protection and adverse government interventions have made such domestic companies uncompetitive and inefficient and, thus, delayed the development of certain countries. Nevertheless, even under the free market regime of the 1990s, infant-industry protection can still be valid with selective industrial policies; otherwise, TNCs will occupy a country's main manufacturing sectors. Fostering domestic enterprises is necessary for the sake of improving managerial skills, upgrading the national technology level, and increasing domestic savings.

Therefore, the fundamental question is which sectors of the manufacturing industry a developing country wants to encourage. In addition, it needs to decide which parts of that sector are to be fostered; for example, whether upper, middle, or downstream industries. The decision will depend not only on the static comparative advantages of the nation, but also on dynamic considerations. Namely, the country needs a clear vision of its industrial structure of the future.

Whatever the sector, parts industries - which supply final producers and are often cited as "supporting industries" - are of vital importance, because a country without such industries will have to import parts and components, and will therefore face foreign exchange constraints. In my discussion, small- and medium-scale enterprises (SMEs), which play an important role as supporting industries in terms of employment, technology, and domestic input demand, are addressed from the perspective of Japan's experience.

II. Japan's experience of SMEs

A. *Policies for SMEs* [1]

Historically, government support for SMEs arose from the unfair treatment such firms experienced due to their weak negotiating position *vis-à-vis* large enterprises, their limited access to conventional financial institutions as well as to technological developments, and their large variations in income and productivity. Moreover, until the 1970s, there was a strong Marxist influence in Japan's political and academic circles that insisted that large enterprises were exploiting SMEs. As will be explained later, this idea of a "dual structure" influenced the government to adopt policies that protected SMEs (Kagami, 1995).

Government SME policies may be divided principally into three parts: the removal of transaction constraints leading to improved productivity; the facilitation of financial resources at preferential rates and the provision of tax incentives; and the development of technology.

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[1] An SME is defined by the number of persons engaged or by the amount of capital. In Japan's mining and manufacturing sectors, SMEs are those enterprises which have: (a) less than 300 persons engaged or (b) less than 100 million yen in capital (approximately US$ 278,000 at the time when the law was promulgated). In this text, SEs are those employing less than 20 persons, MEs those with between 20 and 299 persons, and large-scale enterprises (LEs) those with more than 300 persons.

(1) The removal of constraints

In 1949 the government passed a law that allowed SMEs to form cooperatives and to strengthen their economic activities through group dynamics. It was recommended that SMEs jointly purchase materials, market and sell products jointly, and establish loans among themselves. To prevent undue pressure from large enterprises in subcontracting, the government introduced a law in 1956 that protected SMEs from payment delays by large enterprises (see table 1). This law legally defined the subcontracting relationship between a prime firm and a subcontracting firm, and the operational procedures on contracts were regulated by measures such as the documentation of subcontracting relationships and written orders. In the case of payment delays, the law stipulated that the prime firm must pay accrued interest.

Government protection of SMEs was furthered in 1963 with the introduction of three new laws. The most important was the Small and Medium Enterprise Basic Law, which aimed at improving the economic and social status of SMEs by increasing productivity and correcting disadvantages. The law recommended that the government provide integrated measures for SMEs in the following eight areas: (1) modernization of facilities; (2) improvement in technology; (3) rationalization of management; (4) deepening of SME structures; (5) fairness in transactions; (6) increases in demand; (7) avoidance of excess competition or market reservation; and (8) good labour relations.

The rapid growth of the Japanese economy during the 1960s deepened its industrial structure; complex supply chains were formed, particularly in the automobile and electronic industries. The Law on the Promotion of Subcontracting Small and Medium Enterprises was introduced in 1970 to reflect this economic expansion. To modernize and to improve fair trade between prime firms and subcontractors, the law strengthened an organization called the Subcontracting Enterprises Promotion Association and gave it the role of matchmaker. The association developed lists of firms that wanted to establish subcontracting relationships. The association's authority for arbitration and dispute settlements was also reinforced.

(2) *Financial and fiscal measures*

There are four government-supported financial institutions for SMEs in Japan: the Shoko Chukin Bank (SCB), the central bank for commercial and industrial cooperatives; the People's Finance Corporation (PFC); the Small Business Finance Corporation (SBFC); and the Environmental Sanitation Business Finance Corporation (ESBFC). The SCB, a bank set up in 1936, offers overall banking services for SMEs. The PFC, established in 1949, specializes in financing micro and small-scale enterprises. The SBFC, set up in 1953, provides long-term loans for machinery and equipment, as well as working capital. The PFC and the SBFC also provide special loans at preferential conditions for specified programmes, such as modernization, anti-pollution, energy conservation and structural adjustment. The ESBFC, established in 1967, specializes in financing hygienic and environmental improvement activities for small retailers and service-related shops.

To help SMEs borrow from commercial banks, the government set up the Credit Guarantee Association in 1963. The weak financial credibility of SMEs as well as their lack of collateral were always considered as drawbacks. Thus, the Association was empowered to guarantee SME liabilities for borrowings from

Table 1

Japan: Laws and policies for small- and medium-scale enterprises (SMES)

	SMEs support laws	*Financial support laws*
1930s		• Law for the Shoko Chukin Bank, 1936 (Law No. 14)
1940s	• Law on Cooperatives of Small and Medium Enterprises and Other Parties, 1949 (Law No. 181)	• Law for the People's Finance Corporation, 1949 (Law No. 49)
1950s	• Law for the Japan Chamber of Commerce and Industry, 1953 (Law No. 143)	• Small Business Credit Insurance Law, 1950 (Law No. 264)
	• Law on the Prevention of Delay in the Payment of Subcontracting Changes and Related Matters, 1956 (Law No. 120)	• Law for the Small Business Finance Corporation of Japan Japan, 1953 (Law No. 138)
	• Special Law on Retail Commerce Adjustment, 1959 (Law No. 155)	• Law on Financial Support for Modernization of Small and Medium Enterprises, 1956 (Law No. 115)
1960s	• Small and Medium Enterprises Modernization Law, 1963 (Law No. 64)	• Law for the Credit Guarantee Association, 1963 (Law No. 196)
	• Small and Medium Enterprise Guidance Law, 1963 (Law No. 147)	
	• Small and Medium Enterprise Basic Law, 1963 (Law No. 154)	

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Table 1 (concluded)

	SMEs support laws	*Financial support laws*
1970s	• Law on the Promotion of Subcontracting Small and Medium Enterprises, 1970 (Law No. 145)	
	• Small Retail Business Promotion Law 1973 (Law No. 101)	
	• Law on Adjusting the Business Activities of Large Retail Stores, 1973 (Law No. 109)	
1980s	• Small Business Corporation Law, 1980 (Law No. 53)	
	• Law on Extraordinary Measures for the Promotion of Technological Development by Small and Medium Enterprises, 1985 (Law No. 55)	
	• Temporary Law on Business Conversion and Adjustment Measures for Small and Medium Enterprises, 1986 (Law No. 4)	
1990s	• Law for the Improvement of Employment Management towards the Reserve Labor Force by Small and Medium Enterprises, 1991 (Law No. 57)	
	• Promotion Law for Efficiency in Distribution Operations by Small and Medium Enterprises, 1992 (Law No. 65)	

Source: Kagami, 1995.

commercial banks, and this was immensely beneficial. Fifty-two associations were established throughout Japan.

With regard to tax incentives, SMEs enjoy relief measures such as reduced rates of income tax, income tax deductions, special reserve allowances, as well as special depreciations, depending on the assistance programmes.

(3) *Technology development measures*

National and local governments provide four types of assistance to SMEs involved in technology: human resource development, orientation and diffusion, basic technology development, and incentives for technology development.

Human resource development is assisted through eight college-level schools run by the Japan Small Business Corporation (JSBC). These provide courses for SME engineers and technicians as well as training for SME technical instructors. In addition, each prefectural government has middle-level vocational schools. Technology orientation and diffusion is addressed by public research centres and local technology demonstration centres; both offer technical expertise and consultation to SMEs. Ninety-five among these centres provide testing facilities. Because it is not cost-effective, SMEs are reluctant to purchase this type of equipment themselves.

Sixteen national research institutes and the JSBC are engaged in the research and development (R&D) of basic industrial technology. The knowledge gained is then passed on to SMEs. Lastly, the Law on Extraordinary Measures for Promotion of Technological Development by Small and Medium Enterprises, enacted in 1985, gives SMEs financial and fiscal incentives to research and develop new technologies.

B. Subcontracting system

The subcontracting system grew out of Japan's wartime experience. In order to encourage small-scale industries to participate efficiently and quickly in weapons production, the government introduced a "designated factory" system in 1940. Under this system, the prime firm placed a long-term order with designated subcontractors; technical assistance was provided as well. The designated subcontractors, on the other hand, were prohibited from trading with other firms. The system did not work well because of its rigidity, but some associations were formed and "*keiretsu*" - the formation of industry groups - fermented.

The "dual structure" argument developed from the coexistence of modern and traditional industries in Japan during the 1950s. Small-scale enterprises (SEs), which mainly belonged to the traditional sectors, experienced low productivity and low wages with old traditional technology, while large-scale enterprises (LEs) were enjoying high productivity and high wages with modern technology. There was a gap between LEs and SEs, and as a result, a dual structure formed. Leftists at the time argued that LEs made use of the subcontracting system to exploit SEs by compressing the profits of SEs. LEs became bigger and bigger by absorbing this rent and by forming monopolies, while the SEs were left behind.

This argument disappeared gradually as incomes grew and virtual full employment was achieved. Still, some wage differences remained between firms of different sizes. As both macroeconomic and external conditions became favourable to Japan, SEs gradually modernized their structures, and the number of medium-scale enterprises (MEs) increased. In addition, SEs and MEs were further integrated into the LEs' production systems. Komiya (1962) altered the existing image of SMEs when he showed that, in terms of capital size, the profit ratio (calculated as profits before tax divided by net worth) was higher for SEs than for LEs. These facts showed that SMEs are more flexible, dynamic, and even more profitable than was initially believed. This suggests that the development of SMEs is vitally important to developing countries.

Another factor is the transaction costs involved in subcontracting. Costs associated with contracts or subcontracts include the drafting, negotiation and safeguarding of agreements. Legal costs should also be included. If a society is based on mutual trust, transaction costs are small; if there is a high level of mistrust, they are very high. From the cost reduction point of view, the subcontracting system has worked well in modern assembly plants, being more efficient and less costly in the long run.

Subcontractors have close ties with upper-echelon firms, and the relationships are quasi-permanent. Contracts usually last for five or six years depending on the development duration of a new model, and they will be extended repeatedly. Price adjustments are made twice a year. The prime firm usually considers a certain amount of profit margin for subcontractors, taking into account the production costs of parts and components. Moreover, the prime firm supplies designs, technology, processing tools, and sometimes financial assistance in the form of capital and/or loans. In return, a stable supply of parts and components is guaranteed by the subcontractors with almost zero-defect quality goods.

Finally, information sharing is crucial in this subcontracting system. If information flows smoothly (technology from the prime firm to the subcontractors, production cost information from the subcontractors to the prime firm), both enterprises share not only risk but also "relational quasi-rent" (Aoki, 1988).

C. Concluding remarks

In Japan SMEs have been fostered mainly through government support policies. Here, some lessons should be pointed out:

(i) The role of government in offering incentives to SMEs is important, but protection should be limited to the start-up period and should not be prolonged, because the profitability of SMEs is higher than was originally believed.

(ii) The formation of industrial networks is essential for efficient production. Social consensus on cooperation and collaboration between different interest groups is required for the sharing of the long-term profits.

(iii) In addition to government initiatives, supply chains can also be established through private initiatives, such as industrial associations or chambers of commerce and industry.

(iv) Care should be taken with institution-building from the beginning because later modification is very difficult. In Japan four financial channels were established under four different ministries: banks under the Ministry of Finance, cooperatives under the Ministry of Agriculture, postal savings under the Ministry of Post and Telecommunication, and SME finance under MITI. Such a structure can make it difficult to control total credit amounts and, hence, money supply. ■

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Small and micro-enterprise development: Lessons from Indonesia

Soekarno Wirokartono *

I. Introduction

I want to thank the organizers for giving me the opportunity to address this session of the Conference on East Asian Development. In Indonesia we have been concerned for many years with the development of marginalized sectors. Lately, as economic growth accelerates, we have been even more concerned to make sure that marginalized sectors participate in the overall development.

I wish I could say that our policy efforts to reach these sectors have been uniformly successful and that I could stand here and tell you the secret to this success. Unfortunately, the reality is not like that. In fact, our interventions to assist the chosen recipients have often failed, with the resources being wasted or spent on those not in need. If we considered the opportunity cost of the funds, the magnitude of the failures would be worse. However, the picture is not entirely gloomy, and there have been successes as well. I very much agree with Mr. Goto that the analysis of these experiences must be incorporated into the programme design with appropriate modifications and adjustments.

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Economic growth in Indonesia in recent years has gone a long way towards eliminating poverty at our current standard, but those remaining in poverty have often been trapped in marginalized groups or regions, not being easily reached by this overall growth. Thus, we are attempting to build our policy based on what we know from both the successes and failures in the past so as to better reach these people. As for the ability of government to improve the lives of people, we must be cognizant of the limit of both our ability and resources when we design direct intervention programmes.

Rather than a dry recitation of the general history of Indonesian policy in the area of small and micro-enterprise development, I would like to share with you two studies I was involved in several years ago. Then I will present a very brief overview on the evolution of policy in the area of directed credit and financial institutions. I will conclude with what I think are the general lessons learned from our experience.

II. Batik in Solo

The first study deals with the traditional (hand) batik industry in my hometown of Solo. Along with Yogyakarta, Solo is the home of these traditional batik shirts (featured prominently at the APEC summit in Jakarta last year). By the late 1980s, we knew that there had been a serious problem in this industry as part of a larger problem with low and relatively stagnant wages in the region. Under the direction of the Planning Agency, a team of consultants undertook a study to find out what had happened.

At the height of the batik industry in the early 1970s, over one-third of all batik workers were located in Solo and Yogyakarta. In the late 1970s, however, the batik industry began to decline rapidly. The reasons are quite complicated, but there are several that are the most important. First, much of the protection awarded this industry, in the form of preferential access to quota constrained cotton imports, was eliminated in the early and mid-1970s. Second, the modern Indonesian textile and garment industry began to develop cheaper machine printed batik, thereby intensifying competition. Finally, consumers' tastes were shifting increasingly, choosing to buy western shirts and other apparel. In any event, between 1978 and 1986, 40 per cent of the jobs in the batik industry were lost. This clearly is not a new story. In every country, as production techniques change, demands shifts, and the degree of competition may also change. What makes our story more ironic is that this industry was once chosen (in the 1970s and even earlier) as a recipient of government support and protection through, among other things, competition restrictions, privileged access to inputs and selected credit. The reasons for this support seemed relatively clear, as the industry was very labour-intensive (thus with a large size of employment), dominated by relatively small *pribumi* firms and located in a high-poverty area.

As the detailed story of this industry would take too much time, I would like to concentrate on some findings of the previously mentioned study. In it three groups of firms were identified: the first group composed of indigenous entrepreneurs who *received* subsidies, the second group of indigenous entrepreneurs who *did not* receive subsidies, and the third group of non-indigenous entrepreneurs who *did not* receive subsidies. When circumstances changed (e.g. demand fell), the difference among these groups' responses was rather striking. Only 25 per cent of the first were able to successfully adjust by diversifying into other lines of business, as opposed to 83 per cent of the second group. Preferential access to inputs by the indigenous entrepreneurs of local cooperatives benefited them only in the short run, as it severely hampered their ability to compete, i.e. in the long run. Interviews revealed that many of the first group sold the rights to manufacturing or managerial capability to survive to those in the second and third groups.

Two other results of this study are important to our understanding of how to assist the development of small-scale enterprises. First, one complaint which the interviewers often heard was the consequences of the high cost of (often due to informal charges) and long delays for telephones. The second was the impact of credit on the ability to successfully adjust to the changed circumstances. During the period of this industry's decline, we had a programme known as KIK/KMKP that provided highly subsidized credit to selected small-scale entrepreneurs. Unfortunately, this programme was not effective because the loans were too small, with too many hidden costs (kick-backs). Furthermore, they were not generally provided to the declining batik and similar activities to fund a change-over in production to other lines of business. In fact, successful non-indigenous and indigenous entrepreneurs often borrowed longer-term funds at or near market rates.

III. Boom on Bali

As part of the same examination of small and micro-enterprise development in the late 1980s, another team of consultants, commissioned by us, looked into the rapid development of the garment industry in Bali, and found a thriving micro-enterprise system. I would like to present some points that I hope will shed light on the more general problems involved in facilitating the growth of small and micro-enterprises.

This story begins in the mid-1970s with the opening of an international airport near Denpasar, the Balinese provincial capital, designed to make the island an international tourist attraction. This created two types of spillover effects. First, greatly facilitated access to international markets was further improved by the telecommunications that the tourist industry required. Second, a number of foreigners (legally and illegally) took up residence in Bali, many of who wanted to remain in Bali for a long period and needed funding to make this possible. In looking around for entrepreneurial opportunities, they seized on the Balinese traditional strength in garments and other handicrafts (then entirely oriented to the local tourist trade). At the time of the study they noted that garment exports had grown from US$ 5 million in 1975 to US$ 65 million in 1987, and that there had been a 70 per cent increase in the number of Balinese claiming manufacturing as their principal employment. Between 1987 and 1991 manufacturing employment continued to grow in Bali at real rates in excess of 11 per cent, compared to the national average of around 7 per cent. Anecdotal evidence suggests that it continued to grow even after 1991 at an above-average rate.

Granting that the airport and telecommunications systems were necessary for this boom, let us look at how the foreign and domestic entrepreneurship evolved. The foreign entrepreneurs did not have a formal ownership claim on virtually anything, including land and production facilities. In the initial period, they organized and supervised production (on a putting-out basis from many houses or very small factories) and often provided credit. However, they quickly transferred whatever expertise they had at this end of the business to their Balinese counterparts and specialized in the design and marketing of products for export. These informal manufacturing partnerships lasted on average less than three years, and by then the Balinese partners no longer needed the expatriate partner. Over time, many Balinese manufacturers have bid for the demands of many foreign designers and marketers, thereby creating a wholesale market. This larger and more efficient market has served to keep prices down, and allowed a rapid expansion in Balinese garment exports. The study concluded that the critical factor was access to low-cost design and marketing information provided by foreign buyer-consultants living in Bali. In 1995, a team of consultants returned to Bali to look into the changes since the late 1980s, and observed that Bali has become a design centre equipped with related industries. Larger scale, foreign and domestic enterprises have set up production along side existing entrepreneurs to meet in a timely fashion the quality and quantity of demands in particularly sensitive foreign markets.

What effect did government policies have? In this case, Balinese garments were not a targeted industry. By the time the government was aware of the growth in this industry and region, the industry was already quite competitive on the world market and did not need substantial assistance. The government policy action that contributed included the provision of the infrastructure that supported the tourist industry, and the benign neglect of immigration policy that would have forced many foreign entrepreneurs to leave before their enterprises were established.

Bali is now at a crossroads. Owing to the success of the tourist and manufacturing industries, wages have been bid up substantially, reducing competitiveness in labour-intensive production that has underpinned the export boom. The challenge of government policy is to assist enterprises to improve efficiency in existing industries, as well as to make the transition to new production and service industries that will allow growth to continue in Bali. In particular, we would like to maintain the role of small-scale enterprises in the business environment there. One of the lessons we drew from this study concerned the role of small-scale foreign entrepreneurs. This study contributed to changing many people's view of this role. Previously we had very high capital thresholds for establishing foreign enterprises, believing that small-scale enterprises were often substitutes for Indonesian enterprises. However, these enterprises, driven by the profit motive, were often very effective in the process of technology (and managerial) transfer, and were often partners in small-scale Indonesian enterprise development.

As policy makers, we should like to replicate the Bali experience in other places in Indonesia. Initially, there was some reluctance to draw any general conclusion beyond that related to the role of small-scale foreign entrepreneurs, but we are now more optimistic. With the rise of per capita income, we have come to witness the development of a much larger middle-class market in Indonesia. It is hoped that the role that foreign entrepreneurs have played in Bali may be replicated internally by Indonesian entrepreneurs providing the design and marketing expertise to new regions to promote their exports to major metropolitan areas like Jakarta, Surabaya and Medan. However, facilitating this development will require at least two things on the part of the government. First, an adequate infrastructure. Small enterprises are disproportionately disadvantaged by an inadequate infrastructure, as they do not have the ability to build extra electricity-generating capacity, phone systems or other infrastructure into their operating costs. The second requirement is to reduce regulations to the maximum extent possible. Regulatory costs do not rise proportionally with revenue, and it is small entrepreneurs that must bear the burden - often single-handedly - of keeping their enterprise in line with central and provincial government regulations.

IV. The role of directed credit

Through much of the 1970s, Indonesia was blessed with significant government revenues from oil. We consciously tried to direct these revenues into rural development as much as possible. Many efforts to do this, such as our rural INPRES (presidential instruction programme) were quite successful in building rural roads, schools and clinics. At the same time, we felt that one of the areas of difficulty was the access to credit in rural areas and for small firms. Thus, a number of programmes were begun, including the KIK/KMKP programme of directed credit to small businesses that I mentioned earlier in connection with batik in Solo. In addition, there was a large programme of financial assistance to farmers for purchasing inputs such as fertilizer and seeds called the BIMAS programme.

From 1983 and through 1990, thinking and policies related to broad directed credit programmes gradually changed. In 1985 interest controls on both saving and lending were abolished, and the BIMAS programme began to be phased out. The bank that administered this programme, Bank Rakyat Indonesia or BRI, had a branch in almost every *kecamatan* (about the level of a county - close to 3,000) in Indonesia, and was faced with a dilemma as to what to do with these branches. The approach they took (loosely modelled after some existing, much smaller, programmes in Java and Sumatra) was to create a financial institution in each of these branches. These branches were designed to be fully fledged financial institutions. They were to collect savings at market rates (the Simpedea programme) and lent at market rates (the Kupedes programme). Both the savings rates and the lending rates had to be competitive. While lending rates were still at a premium to urban-based working capital rates, they were equally significantly below the local moneylender rates. It was observed that small entrepreneurs often needed a place to save as well as borrow, particularly when their income was highly cyclical. In addition, for historical and other reasons, Indonesian banks had not developed much their expertise in lending to smaller-scale enterprises (this is still an area of weakness). The BRI "unit desa system", as this is known, has effectively demonstrated the feasibility of small-scale, rural financial institutions. In fact, while serving rural needs, these unit desa systems have also become a profit centre for BRI.

Rapid elimination of restrictions in 1988 on new banks and bank branches in the still largely urban banking system led to a very rapid credit expansion, but did not lead to what policy makers felt was sufficient emphasis on small-scale lending. In 1990, the KIK/KMKP programme of subsidized targeted lending to small enterprises was terminated because of its ineffectiveness and abuse. It has been replaced with a system (KUK) that mandated each bank to channel at least 20 per cent of its lending to small enterprises. In 1993, the 20 per cent rule was further refined by allowing banks to specialize in small-scale lending and sell the share of their portfolio above 20 per cent to banks that did not want to so specialize (international banks for example). More recently policy has also focused on broadening the types of equity and debt instruments available through the capital market. It is anticipated that, as larger firms go directly to the bond and equity markets, banks and bank branches will be forced to serve a smaller-scale clientele.

V. Lessons from these experiences

In concluding, in Indonesia we have been moving towards assistance to marginalized sectors, which is more in line with market signals and less "micro-managed" by the government. We feel strongly that there are positive externalities in developing small enterprises and we want to foster them. We observe that successful small businesses have formed the social and economic core of most towns and urban areas, and that they have functioned as the seed-bed from which larger enterprises spring when conditions are appropriate. We are still aware that our present infrastructure and regulatory system, in addition to the banking system, tend to be biased against small business development. We would like to foster an economic and industrial system that features dynamic firms of all sizes. We also recognize, however, that with the best of intentions as in Solo government intervention can be counter-productive, or as in the case of Bali an active entrepreneurial group can form almost unnoticed.

Where does this leave us? First, while our infrastructure problems are massive, we have tried to improve the quality of transportation, energy and telecommunications in collaboration with the private sector. Second, we have taken a hard look at our regulatory system, and tried to phase out many of those on labour, trade and industry left over from an earlier, more "micro-managed" era. Most of these now serve to extract rents from the private sector, and are disproportionately hard on small enterprises. Many additional regulations had been put in place by provincial or local authorities that raise costs or deter entry. The central government has long realized that we are in a partnership with the private sector, but unfortunately many local administrations are not as farsighted. Thus, we have begun an initiative to assist the private sector by reviewing local regulations in legality and effectiveness. Third, as I have already mentioned, a number of initiatives have been enacted in the area of financial and capital markets. We hope that these will pay off by forcing the banking system to address the needs of small businesses more effectively, by pulling many large firms out of their client base. In addition, the KUK programme, that directs 20 per cent of the credit of the banking system to small firms, is also designed to assist banks in finding this niche. Finally, on a regional basis, we have begun a programme to assist those in poverty in designated left-behind villages. Again we have attempted to take an integrated and hands-off approach. In a coordinated programme, we are putting in place the infrastructure required to effectively connect these areas with the nearest urban centres or transport corridor, or to supply missing schools or clinics or other infrastructure deficits, as indicated by the local people. At the same time, designated groups within each of these villages have been given approximately US$ 10,000 as working capital in an entrepreneurial endeavour of their choosing. This programme has only recently got underway, and while the returns seem quite positive, it is still too early for an effective appraisal.

Thank you for your time and attention. I hope that I have been able to effectively share some of our experience in Indonesia with you. I look forward to learning more from you and bringing this added knowledge home. ■

Comments

Janet Farooq[*]

Before focusing on the problem of marginalized sectors, I should like to make a few general observations on the conditions for achieving rapid and sustained economic growth, without repeating what has been discussed in the other interventions which have covered many interesting and relevant points. As befits the UN's economic arm in this region, ESCAP has been undertaking a number of research and exchange of experience activities in this area over the last few years for the benefit of countries in the Asia and Pacific region, particularly the least developed countries, the economies in transition as well as those in the South Pacific. ESCAP has also done some recent research, bringing together the best practice ideas for poverty alleviation programmes. As I do not have much time and have several points to make, please note that the evidence and analysis to support the following remarks can be found in the reports on these two areas listed at the end of this statement.

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I. Overall remarks on the conditions for rapid and sustained economic growth

A set of relatively stable and consistent macroeconomic fundamentals is basically a necessary but not a sufficient condition, as it is very difficult for any economy to grow when the key fundamentals are way out of balance. However, while the governments of the East Asian newly industrializing economies (NIEs)[1] paid attention to inflation, interest rates and exchange rates, policies affecting these indicators were consciously complimented by other, more direct and selective interventionist measures. Policies affecting macro fundamentals have continued to be important for maintaining growth and competitiveness in their export-oriented economies over a sustained period in a rapidly liberalizing and globalizing world economy.

The existence of a sound and credible legal system of economic institutions was critical. Both the land ownership system and the contract enforcement mechanisms were basic to providing a conducive environment for investment. Countries where the security in the use of land is missing and/or there are problems of enforcement of contracts of all types, for labour, investment, trade, as well as in the financial system, are not likely to develop over the medium to long run. This does not necessarily mean private land ownership but that land markets function efficiently, and is independent of whether the driving force behind the development effort is the public or private sector.[2]

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[1] These are defined by the UNCTAD secretariat to include Hong Kong, the Republic of Korea, Singapore and Taiwan Province of China.

[2] This is illustrated by the examples of China and Viet Nam, where some degree of liberalization led to initial rapid growth but where the lack of well developed land and contract enforcement systems then became increasingly visible constraints.

The building of a partnership for development between politicians, civil service and business, the treating of each other as compliments and not opponents, was a very different experience than that in many developing countries. However, in the East Asian NIEs the development of a common economic objective and its surrounding government/private sector interactions did not usually go beyond the large public and/or private business elite, with only Taiwan Province of China showing interest in the entire formal economic sector including small- and medium-sized enterprises (SMEs) from the start.[3]

In such a situation there can arise, and has arisen, the phenomenon of regulatory capture, as parts of the business community get too close to government, have too much influence on policies to the exclusion of other concerns, or can pay for favours. Therefore the concept of a partnership still needs to rest on the separation of motivations and functions.

While the legislation of suitable policies is relatively easy and has been done in many countries, the implementation of these policies is difficult and takes time. This is where many, many countries fall short. Therefore it is the conditions conducive to effective and sustained implementation of policies which are crucial.

Performance criteria and disciplines, such as the need to demonstrate competitiveness on international markets and to increase exports, provide a necessary check and allow incentives to resemble market-based ones, at least in part. The enforcement of these criteria was aided in the East Asian NIEs by the dominance of bank loans as a source of finance as well as the governments' close links with banks.

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[3] This is reflected in the analysis of savings which were primarily generated from the formal, wage earning and corporate sectors. These sectors had elaborate programmes of institutionalized savings (provident funds, postal saving schemes, tax breaks for reinvestment by firms, etc.) which helped to increase the level of monetized savings and to redirect it to investment.

These countries also managed to make being a government employee a respected, sought-after job, and were able to attract top professionals to government jobs. The need for civil service reform to emulate this model is recognized in many of the lagging economies in Asia.

II. Marginalized sectors in the context of East and South East Asia

The notion of marginalized sectors is based on the premise that these sectors are not benefiting sufficiently or as much as expected from the trickle down of economic growth, for one reason or another. It cannot be assumed that SMEs or agricultural ventures are necessarily marginalized as in many economies they are dynamic and flourishing.[4] For example in Singapore, which is often viewed as a thriving economy of large enterprises and where government attention to SMEs is of relatively recent origin, SMEs account for 90 per cent of total establishments, 44 per cent of employment, 24 per cent of value added and 16 per cent of direct exports. The East Asian NIEs had by and large low levels of population pressure, comparatively low rates of population growth even in the 1980s and relatively small agricultural sectors. These have been reduced further in recent years. Among them only the Republic of Korea has ever reported poverty figures, with a head count index of poverty of 28 and 16 per cent in rural and urban areas respectively in 1970, 4 and 5 per cent in 1984, and probably less today. For all the East and South East Asian countries combined, the percentage of the population below the poverty line was around 13 per cent in 1985 and 11 per cent in 1990, compared to almost 50 per cent in South Asia and 30 per cent for all developing countries in the later year. Even the informal urban sectors were comparatively small, if at all existent. Thus, while emphasis varied, the marginalized sectors were not a sizeable problem, and could be tackled directly and quite cheaply without diverting resources from the major policy areas. Whether this situation holds in many other countries is doubtful.

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[4] This is not identical with these sectors necessarily being the primary focus of government policies as they may be benefiting from the rapid growth of other sectors, depending on existing links.

The trickle down of growth was supported in the East and South East Asian countries by making available subsidized but limited credit through directed credit schemes, or the requirement of banks to lend at least a specified proportion of their finance to SMEs or the rural sector. But this was not the end of the story. For example in the Republic of Korea, there was and still is an interesting and sometimes mandatory subcontracting arrangement between the larger firms and SMEs. Considerable support for access to technology and for improving management and marketing was also common. Malaysia and Thailand had and still have systems to promote research and development agriculture. These are demand driven through close ties to the farming communities, either through their paying a levy to finance in part the research and also sitting on the boards where research decisions are made (Australia has a similar system), or the farmers being an integral part of the testing procedures and feedback to researchers. All the governments financed the provision of economic infrastructure for the entire economy as well as programmes to provide an adequate social infrastructure and human resource development.

These policies were partially, if not completely, successful. In Malaysia, for example, there is now no officially reported poverty. However, in Indonesia, the Republic of Korea and Thailand, the number of urban poor has either increased or has been reduced much more slowly than has poverty in rural areas, owing mainly to rural/urban migration of labour with low-skill levels. This implies that the informal urban sector is a growing concern and new policies have to be devised to cope with this problem. The credit programmes were not a big success for these sectors as credit did not reach those in need, and was usually too small in relation to demand. The more successful ones were based on a combination of self-targeting and good performance criteria. It is interesting to note that there has been a new and visible policy emphasis on SMEs in the Republic of Korea and Singapore in the last several years, including increasing their ties with larger firms and their ability to enter the export market. However, these policies can be attributed more to a desire to reduce relative inequality in income than to alleviate poverty.

The East Asian NIEs do not offer much help as models for policies for marginalized sectors in other developing countries, or even those in South East Asia, where these sectors occupy a much larger proportion of the population and economy. In fact one could argue that some countries risk being totally marginalized in the world economy and need to think of strategies which maximize the importance of being unimportant. Nevertheless, research on policies for marginalized sectors in the Asian and Pacific region suggests several critical elements for their success.

III. Policy considerations for marginalized sectors

While the terms "ownership" and "empowerment" are used a lot in the literature these days, they are important concepts in terms of making programmes and policies operational and sustainable. They have to do with bottom up rather than centrally designed programmes, and increasing opportunities for the intended beneficiaries to use programmes to improve their productivity, employment and ultimately incomes.

The use of self-targeting in programmes, whereby instruments are designed to provide incentives for only the target groups to participate, and disincentives for others, is a growing trend. Instruments used include levels of interest rates at or above market rates so that those having relatively easy access to normal channels of finance are not interested, or providing only basic training so that those with more education or educational opportunities are discouraged, or differential payment schemes. The idea of collective or community guarantees for loans have functioned well, as have programmes designed for women who seem to have a better record of responsibility for using financial resources in a productive manner and for repaying.

The need to pay for at least part of the assistance provided is gaining recognition, as both a way of ensuring the usefulness of programmes offered and of designing sustainable programmes that do not die when the initially available subsidized finance dries up. The most successful poverty alleviation programmes all charge at least nominally for services rendered, whether these are loans, basic education, technical training, health services, or infrastructure such as housing, water, etc., thus helping to ensure some degree of sustainability.

It is the lack of access to finance which is most often seen as the primary obstacle to the economic development of marginalized sectors. By definition, persons in these sectors do not have much savings and yet have primarily to rely on their own resources for investment. Thus, liberalizing the financial system by reducing or eliminating directed credit programmes for specific large industrial sectors, thereby reducing segmentation in the market so that all can compete on an equal footing, is often fundamental. However, there will remain a problem of providing funds to the marginalized sectors owing to the high transaction costs incurred by those offering the finance. This is the crux of the problem, not the interest rate to be paid by the borrower, whose alternative is the informal financial market, where interest rates are extremely high. Thus most credit programmes for marginalized sectors now charge interest rates at or above market, rates but far below the rates in the informal financial sector. However, more efforts are needed to find ways of coping with the transaction cost and creditworthiness problems. There are now many variations on the Grameen Bank for the very poor throughout Asia. Also efforts in the formal financial system, such as the newly proposed rural development bank scheme in Thailand, are based on market rates of interest for borrowers without a government subsidy for the transaction costs of the institution. Often the loan application rules including those on collateral are not suitable and are too complicated for the marginalized sector participants. Some have tried to overcome this with collective guarantees, or for SMEs with ratings by an industry association, or by requiring letters of recommendation from larger firms.

There seems to be merit in linking access to finance with other forms of assistance such as training, or with production arrangements such as subcontracting. This has been done through performance criteria in East and South East Asia and helps to ensure that the finance is used for productive purposes, as well as meeting another need at the same time.

There is a gap appearing in the credit arrangements between poverty alleviation programmes offering very small amount loans, which are to be repaid quite rapidly, and the special loan facilities for SMEs. There does not seem to be any way yet devised to help microenterprise graduates to become SMEs. More thinking is needed on this aspect if the poor and marginalized are to be integrated into the mainstream economy. One idea would be to devise modalities for linking microenterprises to SMEs, much as SMEs have been linked to large firms.

The organization of self-help groups for the very poor and industry groups for SMEs seems to be a necessary step to empowerment, so that these groups may represent their interests to those offering assistance and organize their own programmes and activities.

Governments need to be concerned that their policies and regulations for the marginalized groups are simplified and that harassment of these sectors by various levels of government is contained. This is a particularly important problem for the growing informal sectors in urban areas.

For the marginalized groups and particularly for agriculture there is a need to develop marketing infrastructures so that price signals can get through. Often, even after prices are deregulated and these sectors are provided with incentives to save and invest, the available marketing and distribution channels are underdeveloped or clogged by middlemen or government marketing agencies. Experience has shown that when price signals get through properly and quickly, the entrepreneurs in the agricultural sector react rationally and diversify or expand production, as the situation warrants.

For agriculture, a mixture of providing research and development, encouraging the endogenization of technologies, broadening access to relevant market information quickly and improving the marketing and distribution systems seems to be the most appropriate approach, rather than focusing on price levels *per se*. Experience, including in Africa, shows considerable progress in terms of quantity and quality of product, timing of sales and levels of income, when these elements are combined and farmers are empowered to participate directly in the market.

Despite much talked about trends to the private provision of economic infrastructure and social services, such as health and education, it is clear that governments will continue to be primarily responsible for providing these public goods for the economy as a whole and the marginalized sectors in particular. They need to be concerned about the equity of access, the accessibility to services and pricing formulae in ways which are difficult for private operators to assimilate.

IV. Conclusions

In conclusion, I should like to suggest that the South East Asian experience is much more important for other developing countries than that of the East Asian NIEs. These were commodity-dependent countries that are now well diversified and experiencing continuing rapid growth. They did not neglect agriculture nor commodity exports but used their natural resources to their own advantage to generate a savings surplus for other investment, through research and development, aggressive and modern marketing, promotional programmes involving education, extension services, provision of information, etc. They still continue to expand their commodity exports, even though these appear as a lower percentage of total exports. These countries were also much more open to direct foreign investment, which played a crucial role in providing modern technology, management and marketing models, competition and the like. They have had programmes for SMEs and marginalized groups from the beginning and have put stress on technical education and science training.

Secondly, there seems to be no obvious answer to the question as to how much attention governments need to pay to the marginalized sectors in their economic policies, and how much the trickle-down effects of other policies are actually responsible for improvements in the economic position of these sectors. Rather, social pressures force governments to take these sectors into account in countries where they are a significant proportion of the population. In this context social policies are also important as the long-term solutions must lie in education, health, etc., for all. For example, simulations with a new econometric model of Pakistan which integrates the real economy with the fiscal position of the government and the social sectors show that with the same amount of investment resources, an aggressive policy of investment in education and health induces in the medium to long term a much more rapid rate of growth of GDP than does a policy of aggressive investment in infrastructure or industry. However, such a policy also causes short-run loss in GDP growth and so is difficult to sustain politically without sufficient external assistance to finance both simultaneously.

Lastly, it seems clear that exposure to the disciplines of the external market is very useful in ensuring that government policies, including those to support selectively certain sectors, are efficient and non-distortionary. The knack of success seems to lie in how to do this while at the same time coping with the needs of the marginalized sectors and maintaining macro balance. This is a very tall order for any government. ■

Annex

Reports by ESCAP relevant to the Conference on East Asian Development: Lessons for a New Global Environment

- "The lessons of East/South-East Asian growth experiences", *Development Papers No. 17* (ST/ESCAP/1474), 1995.
- "Enhancing the role of the private sector in development", *Economic and Social Survey of Asia and the Pacific, 1996,* Chapter IV (ST/ESCAP/....), forthcoming.
- "Reform and liberalization of the financial sector", *Economic and Social Survey of Asia and the Pacific, 1995,* Chapter IV (ST/ESCAP/1466), 1995.

- "Mobilization of domestic financial resources for development: The Asian experience", prepared by Azizul Islam, Director, DRPAD, UN ESCAP, for presentation at the Ad Hoc Expert Group Meeting on Mobilization of Domestic Financial Resources for Africa's Development: Retrospects and Prospects, 11-13 December 1995, Addis Ababa.
- "ASEAN policy experience: a comparative analysis", Azizul Islam in *Towards an Asian Economic Area*, V.R. Panchamukhi and Rehman Sobhan (eds.) under the auspices of the Research and Information System for the Non-Aligned and Other Developing Countries, New Delhi, and South Centre, Geneva.
- *Incidence, Causes and Correlates of Poverty in Asia and the Pacific*, report to the Committee on Poverty Alleviation through Economic Growth and Social Development, second session, September 1995 (E/ESCAP/CPA(2)/2).
- *Review of Target-group Oriented Poverty Alleviation Programmes, with a Focus on their Effectiveness and Impact in Selected Developing Countries of the ESCAP Region*, report to the Committee on Poverty Alleviation through Economic Growth and Social Development, second session, September 1995 (E/ESCAP/CPA(2)/2).
- *Causes, Characteristics and Consequences of Poverty: Reasons for and modalities of the use of targeting in selected poverty alleviation programmes in the ESCAP region* (ST/ESCAP/1591), forthcoming.
- *The informal sector and urban poverty alleviation in Asia and the Pacific* (ST/ESCAP/1600), forthcoming.

Session 4

POLICY OPTIONS IN A GLOBALIZING ENVIRONMENT

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* Written statement unavailable.

Policy options in the changing international environment

Murray Gibbs[*]

I believe that this session should address two fundamental issues. These are:

(i) whether East Asia policies are still relevant in the world of globalized production?

(ii) whether East Asia policies can be emulated in the post-Uruguay Round multilateral trading system?

I intend to discuss the second case in my intervention. In doing so, I assume, as do most of the papers presented at this Conference, the validity of the "flying geese" paradigm, and will address the question as to whether this paradigm is reflected in multilateral rules and obligations. One can respond affirmatively. The principle of differential and more favourable treatment was intended to assist those "geese" which found themselves further back in the pattern. It intends to help them at least to keep up with the leader, if not to catch up with him, by giving them special trade benefits and imposing fewer obligations restricting the scope of their trade and industrial policies.

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The *Trade and Development Report 1994*, in its section on the "Visible Hand", discussed the policies followed by successful countries in East Asia. It observed that while these economies (including Japan, the Republic of Korea, Hong Kong, Taiwan Province of China and Singapore) had not followed a set model, their development strategies had contained at least some of the following elements:

(i) flexible use of protection for infant industry development;

(ii) export promotion through various forms of subsidization;

(iii) active investment policies aimed at channelling investment to priority sectors and subjecting foreign direct investment (FDI) to specific conditions;

(iv) acquisition of technology, including through these investment policies.

There is a perception that the emulation by developing countries of the selective strategies followed by the successful East Asian newly industrializing economies (NIEs) may no longer be possible for two reasons. First, the growing mobility of capital, prompted by increasing liberalization in the international capital market and the globalization of production by the transnational corporations (TNCs), makes it difficult to impose regulations on enterprises for industrial policy purposes. Second, the intensification of multilateral trade disciplines and the extension of their scope as the result of the Uruguay Round prohibit or constrain the use of some key policy instruments which have been central to the export success of these countries. It is increasingly argued that in response to this dilemma the only viable option may be to adopt *laissez-faire* policies rather than to pursue a more selective strategy along East Asian lines.

However, the current discussions tend to emphasize extremes. Certain writers overstate the constraints on development policies of the World Trade Organization (WTO) obligations, while others excessively minimize the impact of these obligations on the scope of policy options. These extreme positions often reflect the extent to which such persons have been associated with the negotiation process and their political inclinations. It would, at this juncture, seem essential for policy makers to avoid generalizations and undertake a more objective analysis of realistic policy options for developing countries.

Developing countries were not unaware of the possible impact of the restriction of policy options on their competitiveness and development prospects. I recall participating in the preparation of a major policy document issued by the secretariat of the Latin American Economic System (SELA), before the Punta del Este meeting. The document expressed the view that the proposals being put forward to include the new issues in the multilateral trade negotiations (i.e. services, intellectual property, investment and technology) might reflect a strategy of "no more Japans", i.e. that the developed countries would encourage developing countries to adopt forms of development strategies that would not result in the emergence of new challengers to their dominance. For example, they would seek to include in the multilateral trade obligations provisions which would encourage strategies based on inter-industry trade, dependence on imported technologies, and on FDI. The objective would be to pre-empt the more self-reliant development strategies that had been followed by Japan, the Republic of Korea, etc., which had resulted *inter alia* in the emergence of strong "national champion" enterprises which could challenge the TNCs of Europe and North America. I do not feel it is useful at this moment to enter into a debate on the motives of the various protagonists in the Uruguay Round. But I maintain that in any case the developing country negotiators were successful in largely preserving the scope for policy options that would enable them to emulate at least the basic elements of the East Asian strategies.

It should be recalled that the policy strategies of the East Asian countries did not take place in the absence of multilateral constraints. When compared with the post-Uruguay Round multilateral rules, these constraints were less stringent in terms of the scope for domestic policy actions, but market access for their exports was also less open and less secure. Furthermore, the constraints faced by each of the East Asian economies differed considerably. For example, Japan became a contracting party to GATT in 1955, but for many years faced discriminatory restrictions owing to the invocation of Article XXXV of GATT by many countries, particularly in Europe. The Republic of Korea did not become a contracting party to GATT until 1967. Hong Kong applied the GATT as a separate customs territory of the United Kingdom, and later became a full contracting party in its own right. Singapore applied the GATT *de facto* from 1966 and became a contracting party by succession in 1973. On the other hand, Taiwan Province of China, which left the GATT in 1950 and whose observer status was revoked in 1972, is only now seeking accession to the WTO (as the separate customs territory of "Chinese Taipei"). Japan became a signatory to all the Tokyo Round Codes on non-tariff measures, while the Republic of Korea, Hong Kong and Singapore accepted only some of them. The Republic of Korea continued to apply restrictions under the balance-of-payments provisions and did not disinvoke Article XVIII:B until the Uruguay Round was well underway.

While the Uruguay Round has clearly increased disciplines as noted above, it has also improved security of market access for exports from developing countries, not only in the markets of the major industrialized countries markets but also in those of developing countries. This represents an improvement over the conditions faced by many East Asian NIEs. As noted above, Japan faced discriminatory quantitative restrictions for many years after joining GATT as many countries invoked the non-application clause against it. The other countries also faced a series of non-tariff barriers, including voluntary export restraints in textiles and clothing under the MFA or as "grey area" measures in other sectors. They also faced the threat of countervailing duties applied without the "injury test" by the United States (until their acceptance of the Tokyo Round Code). On the other hand, the developing countries in this group benefited from the Generalized System of Preferences (GSP) treatment in the major markets, and in fact, they were among the beneficiaries showing the highest rate of utilization of GSP schemes.

The defining feature of the WTO is the imposition of a more homogeneous set of multilateral obligations. From this perspective, the impact of the Multilateral Trade Agreements on the scope for the kinds of policy measures followed by the successful East Asian countries are summarized in the following paragraphs.

As a result of their membership in the WTO, the multilateral obligations of developing countries as a whole have increased in important ways. This has been the result of the "single undertaking approach" under which disciplines of the Multilateral Trade Agreements apply to all member countries; the tariff bindings, which cover all agricultural and a large number (up to 100 per cent in some countries) of industrial products; commitments on trade in services (which differ significantly among countries); and the acceptance of intellectual property protection norms as embodied in the Trade-Related Intellectual Property Rights (TRIPs) Agreement. To this must be added, for example, the abolition of quantitative restrictions and licensing systems entailed by the disinvocation of Article XVIII:B by a number of developing countries.

However, most multilateral agreements provide developing countries with longer time periods to implement the obligations of the Multilateral Trade Agreements, while least developed countries are usually accorded even more extended periods. In addition, in some instances developing and least developed countries have lower levels of obligations.

The longer periods for implementation permit developing countries to retain more policy autonomy for an additional period, which may, in certain circumstances, provide them with additional options for enhancing their trade competitiveness. Developing countries must draw up their trade and economic policies in full cognizance of their multilateral rights and obligations. These obligations would not seem to preclude their emulating the basic elements of earlier strategies, although in the context of more open markets (both for imports and their own exports). Least developed countries, in particular, will have considerable freedom of action, at least for ten years under most of the Multilateral Trade Agreements. Each country enjoying the differentiated and more favourable treatment in the form of exemptions and longer phase-out periods must decide whether these measures are useful tools for promoting its trade and development. If so, they should be effectively put to use; if not, such measures could be phased out even more rapidly than foreseen in the Agreements.

It should be borne in mind that resort to some of the provisions for differential and more favourable treatment, which provide greater freedom of action for developing countries, may be challenged by trading partners. For example, the United States and the European Union have drawn up "action programmes" aimed at maximizing the trade benefits of the Multilateral Trade Agreements through aggressive action, including by challenging "borderline" measures, where the rules are open to interpretation. There have already been pressures on developing countries to dispense with the rights to special and differential treatment that they negotiated in the Uruguay Round.

With respect to *infant industry protection*, it should be noted that none of the East Asian NIEs ever formally invoked the "infant industry" clause of GATT (Article XVIII:C), but quantitative restrictions were covered under the developing country balance-of-payments provisions of Article XVIII:B. The Republic of Korea, for example, justified quantitative restrictions under this Article. Taiwan Province of China, not a contracting party to GATT, had a freer hand in maintaining quantitative restrictions.

This possibility still remains available for developing countries meeting the balance-of-payments criteria of Article XVIII:B, although, the "Understanding" relating to this Article strongly discourages resort to quantitative measures and provides for stricter multilateral surveillance. However, to the extent that tariff rates remain unbound or bound at ceiling levels above currently applied rates, they can be increased to protect "infant industries". It should be noted that tariff bindings are negotiated, not imposed, while some countries have not been willing to accept more than a limited range of bindings on industrial products, others have followed a deliberate policy of binding tariffs, often at relatively low rates, as insurance against future protectionist pressures.

The Uruguay Round has resulted in the binding of all tariffs on *agricultural products*, albeit some at very high levels. Japan and the Republic of Korea also tend to maintain very high levels of protection on certain agricultural products and managed to negotiate the inclusion of Annex V to the Agreement on Agriculture, thus escaping even the tariffication requirement for rice, although providing a quantitative minimum access commitment. Developing countries have more flexibility in the application of export and domestic subsidies in the agricultural sector, both in terms of the quantitative limitations negotiated and the measures covered. Least developed countries have no obligations in this respect.

The Agreement on Subsidies and Countervailing Measures defines "subsidy" for the first time, tightens the disciplines on subsidies and extends these disciplines to all WTO members. However, it is perhaps this Agreement that contains the most meaningful provisions on differential and more favourable treatment, some of which are not subject to any precise time limits. For example, the least developed countries and a list of 20 other countries with GDP per capita less than US$ 1,000 are exempted from the prohibition of export subsidies so long as they remain in these categories and so long as certain thresholds, based on shares of world markets for products benefiting from export subsidies are not reached. Other developing countries are subject to an eight-year phase-out of prohibited subsidies; however, an extension of this timetable can be granted by the Committee. Export subsidies will have to be phased out in two years if the developing country concerned becomes "competitive" in a particular sector, defined as 3.25 per cent of world trade in such a sector for two consecutive calendar years. One would have to examine the implications of this figure for individual countries. Developing countries are also exempted from the prohibition on the use of subsides contingent upon the use of domestic over imported goods for five years, and least developed countries for eight years.

Specific subsidies (i.e. those limited to certain enterprises and not granted according to neutral, objective criteria) are "actionable". "Remedies", however, can be applied against "actionable" subsidies of developing countries if injury to the domestic industry of another member, serious prejudice to its interests or nullification of tariff concessions or other WTO obligations can be demonstrated. In addition, there is a set of non-actionable subsidies, including those which are intended to promote basic research, agriculture and regional development.

Strictly speaking, the Trade-Related Investment Measures (TRIMs) Agreement did not modify GATT obligations, but simply clearly identified those *investment* measures which were incompatible with GATT Articles, confirming the findings of an earlier GATT panel decision (Canada FIRA case). The TRIMs Agreement reaffirms the prohibitions in GATT Articles III and XI, of two main types of investment measures; however, these include local content requirements (which still can be applied by countries invoking Article XVIII:B) and trade balancing requirements, but leave a wide range of measures untouched. In principle, local content requirements can still be used by developing countries invoking the balance-of-payments provisions, but, as noted above, such departure from price-based measures would have to be justified. In some cases, prohibited TRIMs can even be introduced during the phase-out period.

Many other TRIMs are still permitted, for example export performance requirements other than those based on "balancing" exports with imports, (if they involve payments to exporters, they fall under the disciplines on export subsidies). However, as the TRIMs Agreement describes the list of prohibited TRIMs as "illustrative", challenges may occur with respect to measures which are not on the prohibited list.

There have been many statements to the effect that the TRIMs Agreement brought investment within the trading system, and obliges countries to grant national treatment to foreign investment. This is untrue: the reference to national treatment in the TRIMs Agreement refers to national treatment for goods, not for foreign investors. The TRIMs Agreement *did not impose obligations to grant national treatment to foreign firms*, as has been stated in certain papers; this is simply incorrect.

The General Agreement on Trade in Services (GATS) involves binding commitments with respect to market access and national treatment *only when these have been specifically negotiated on a sectoral and subsectoral basis and included in the schedules of commitments*. The majority of such commitments relate to investment measures (i.e. "commercial presence"), and market access for foreign service suppliers can be made conditional on access to networks and technology. It does not oblige countries to remove any measure or to provide national treatment, so long as the most-favoured-nation principle is respected (there are possibilities for deviation from most-favoured-nation treatment as well as provisions for regional integration which provide for greater flexibility for developing countries.

Investment came into the GATT/WTO multilateral trading system through the GATS, not TRIMs. Virtually all developing countries have made some commitment with respect to investment ("commercial presence") in their GATS Schedules. However, in many cases these have been of limited coverage, confined to those sectors where the country concerned wished to encourage investment, which is normally subject to specific conditions and qualifications laid out in the Schedules. The GATS Schedules have the advantage of clarity in that a country has no other market access or national treatment obligations than those which are included in its own Schedule. Article IV of the GATS also sets up an obligation to facilitate the participation of developing countries in services trade through the negotiations-specific commitments, which would strengthen their domestic services capacity, *inter alia* through access to technology, and improve their access to distribution channels and information networks.

All access and national treatment commitments, made on the basis of reciprocity, can be traded of for commitments on services of tariff concessions in goods. Furthermore, developing countries can make access conditional on actions by the foreign firms benefiting from it, e.g. such as access to technology or information networks and distribution channels (in other words, the legitimacy of TRIMs in the service sector has been recognized). However, only a few developing countries (notably India and Indonesia) have included such conditions in their schedules.

Perhaps the most dramatic extension of the multilateral trading system was through the TRIPs Agreement, which establishes the basic *intellectual property* norms of World Intellectual Property Organization (WIPO) as multilateral trade obligations, to be applied consistently with the principles of national treatment and unconditional most-favoured-nation treatment. It includes entirely new and sweeping obligations, the most important being that all products and processes (excluding plants and animals) are patentable. Certain key policy tools, such as compulsory licensing, are still permitted but significantly restrained. The TRIPs Agreement's real impact will only become evident with the experience of its implementation. The proponents of the TRIPs Agreement have already shown their desire to reach interpretations that would extend the constraints over developing countries' autonomy in this area to a maximum.

However, the TRIPs Agreement contains a number of provisions under which developing countries may take action to influence their access to technology, for example through compulsory licensing requirements or measures designed to deal with anti-competitive practices. In addition, developing countries have up to ten years to implement patent protection in areas of technology not previously protected. Most developing countries will face difficulties in enforcing the TRIPs Agreement owing to the absence of resources to train and maintain the necessary officials. It should be noted, however, that the TRIPs Agreement does not prohibit parallel imports or compulsory licenses, nor reverse engineering, as has been stated in certain papers. It also permits action to be taken against anti-competitive practices arising from the abuse of intellectual property rights, such as practices which unreasonably restrain trade or adversely affect the international transfer of technology. Also countries remain free to take action necessary to promote public health, nutrition, etc. Article 40:2 specifies that nothing in the TRIPs Agreement prevents members from specifying licensing practices and conditions in their legislation.

The TRIPs Agreement differs from the other WTO multilateral trade agreements in that it contains subjective language ("reasonable", "appropriate", etc.) to a much greater extent. As I have noted, this is likely to be at the centre of future disputes on the interpretation of the Agreement. In fact, there have already been a number of cases where major developed countries have exerted pressure at the bilateral level for developing countries to forego certain rights in the TRIPs Agreement, including but not limited to those involving the time limits for implementation of the Agreement.

In summary, while the WTO multilateral agreements have reduced the scope of policy options, policy measures comparable to those applied by the East Asian countries can still be applied, particularly by the least developed countries and the other countries listed in Annex VII to the Agreement on Subsidies and Countervailing Measures. The main constraints would seem to be those posed by the ability of the countries concerned to devise and execute such policies, particularly those which involve negotiations with developed countries or TNCs, and to do this within the time periods available, which differ between countries and from one Agreement to the other.

In any assessment of designing appropriate policies under current international obligations, it should be recalled that the East Asian countries had to exercise a considerable amount of policy ingenuity and administrative and diplomatic skills to maintain some of their policies. In this respect, both formal and informal government-business links which played such an important role in East Asia's success are likely to be of growing importance in the new trading environment, and measures to strengthen government-industry partnerships deserve closer attention by developing countries.

The restrictions of the WTO multilateral agreements on state intervention have been exaggerated. Government provision of information to exporters and changes to exchange rates remain permissible policy instruments. Policies can be designed in such a way that they serve both macroeconomic purposes and others, such as increasing the international competitiveness of certain industries. State-trading enterprises may continue to operate as long as they respect commercial principles. Many of the policies identified earlier with a dynamic profit-investment nexus will still be permissible under the new trading rules. These include general fiscal concessions to corporations, the provision of subsidized R&D and measures to promote corporate savings and investment. Given that these policies can have considerable influence on promoting technological upgrading and international competitiveness, strengthening these areas of policy-making cannot be emphasized too strongly.

The fundamental question would thus seem less that of whether the WTO rules permit an emulation of the East Asian model than that of whether the model itself is still relevant in the light of globalization of production and liberalization of world markets for trade in goods and services, investment and finance. This is a question that will be further examined by UNCTAD. Many of the most important challenges will come in the future with pressures to direct the multilateral trade rules to deal with the phenomenon of competition between regulatory regimes. The agenda to be decided by the first WTO Ministerial Meeting in Singapore, in December 1996, will indicate the future direction of the multilateral trading system in this respect. ■

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Lessons for Africa from the South East Asian development experience

Walter Cabrera *

I. Introduction

Africa is a continent full of contrasts. Let me explain. On the one hand, Africa's situation is characterized by mass poverty, food shortages and famine, narrow and weak productive bases with high dependence on exports of a few commodities, an extremely weak framework of physical infrastructure and, most damaging of all, a weak base of human resources in terms of the skills necessary to underpin sustainable development efforts. On the other hand, Africa is endowed with an enormous wealth of natural resources, many of them largely untapped. Similarly, we could view Africa's large and growing population from a different perspective and see it not as a problem but as a huge potential market, a virgin territory for the bold entrepreneur. In a way, Africa's current plight reminds me of what the German scientist Alexander Von Humboldt said about my own country, Peru, at the turn of the century, after making an exhaustive evaluation of my country's resources. He referred to Peru as "a beggar sitting on a golden stool".

Yet, not everything in Africa has to be viewed with pessimism. There are many bright sparks that signal the desire of the continent's people for a change and for economic and social improvement. To name a few examples, we could mention the peaceful transition in South Africa, where the country has unshackled itself from the irons of bigotry, economic repression and the exploitation of the many by the few. South Africa is redesigning itself in order to assume an important role in the continent's development in the future. Making a parallel with the South East Asian experience, Africa may have just laid a promising goose egg and we may soon see the African flying geese led by South Africa. We could also mention Uganda, which is literally rising, like the Phoenix, from the ashes left by a succession of murderous dictators, to undertake radical and far-reaching economic and social reforms for the benefit of its people. This is only a sample of the palpable yearning of the African people's desire to shake off underdevelopment and assume a more meaningful role in the world economy. Many other African countries are also taking courageous steps towards democracy, political plurality, and stable, transparent and accountable governments. Unfortunately, progress seems to occur a little bit like the rumba, two steps forward, two steps backwards.

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II. How can Africa learn from the South East Asian experience?

As this Conference on East Asian Development is clearly demonstrating, there are many lessons to be learned, and there is more than one interpretation of the East Asian miracle. Our focus for this particular session is to find ways and means to adapt and apply the experiences of South East Asia in a changing and globalizing international environment. It goes without saying that the most cost-effective way to learn is from the successes and failures of others. However, we must undertake this learning process with pragmatism instead of theoretical rigidity. A *sine qua non* condition to facilitate the learning process is that countries must assume a clear national identity, a sense of unity and common purpose. In Africa this would mean an end to tribalism and divisive internal conflicts, either ethnic, religious or political. By this I do not mean that an individual has to lose his or her cultural identity. You can be proud of your cultural or religious identity, but you must put first your sense of national unity. Similarly, no region can develop while its government pursues policies tainted with political patronage and a kleptocratic culture. I believe that one of the principal lessons from the South East Asian development experience is that governments need strong and efficient bureaucracies guided by meritocratic values and a clear sense of purpose, which must be aimed at "serving" the economic agents and providing an enabling environment in an atmosphere of partnership and cooperation. The will for change and development must come from the African countries themselves; it cannot be imposed from the outside. This determination was reaffirmed by the recent Summit of the Organization of African Unity in Addis Ababa.

I believe that international organizations in general, and the United Nations system in particular, have a very important and constructive role to play in supporting development efforts, not by imposing development paradigms but by serving as catalysts for ideas, promoting the sharing of experiences, widely disseminating knowledge, and providing technical assistance whenever required. Governments themselves must do the rest. Development, as we all know, cannot take place in the midst of armed conflict and civil strife. Similarly, development cannot occur while physical, institutional and human resource infrastructures remain weak, and where efforts to address these difficulties are hampered by declining terms of trade, protectionism and unbearable debt burdens, to name a few. In other words, the efforts of African countries must be supported by the international community to be sustainable. As the United Nations high-level segment of the Economic and Social Council recently concluded, priority attention for Africa is required in the areas of conflict prevention, management and resolution; external debt; financial flows; international trade; capacity building; South-South cooperation; agricultural productivity and food security; population growth; and increasing the role of women in development.

The recent trends in international globalization and liberalization are presenting us with challenges and opportunities. These world changes are irreversible and we must adapt to them. The creation of the World Trade Organization has been hailed as a triumph and a major step towards the full integration of all countries in the global trading system. However, we must remain vigilant against disguised protectionism, thinly cloaked under the guise of safeguarding against "unfair" competition. The world cannot afford double standards that threaten the growth prospects of developing countries. The triumph of the "market" and liberalism is supposed to demonstrate that the influence of the state must be limited and that the private sector must assume a larger function. While recognizing the paramount role of private market forces, we are learning here that the state must also play a key role. Paraphrasing an old quote, it seems that the news about the death of the state has been greatly exaggerated.

There has been a veritable revolution in the way global financial intermediation is taking place. Many countries are still recovering from the hangover of the "Tequila effect". To take advantage of new developments in financial markets, countries have to develop and strengthen their own financial intermediation systems. This is a key ingredient to mobilize financial resources for development. Africa, unfortunately, is far behind in this regard. Let me illustrate this point with an example. It is very difficult to mobilize rural savings in many parts of Africa, given the weakness of the banking system. Moreover, it becomes particularly difficult if the major form of saving is the accumulation of cattle. This is a significant challenge since it entails changing cultural mind-sets. However, it is not an impossible task, and substantial progress is already being made. In this regard, the Asian experience in developing their capital markets and fostering an efficient financial intermediation system could be extremely helpful to African countries' attempts to mobilize domestic and international financial flows for development.

The new globalizing and liberalizing international environment has also been accompanied by a decrease in official development assistance (ODA) to African countries partly as a consequence of, among others, the budgetary stringency in industrialized countries, an increase in the number of countries requiring assistance, and the triple A phenomenon of aid fatigue, aid pessimism and aid cynicism. Let me explain what I mean. Aid fatigue emerged as the number of countries requiring assistance grew simultaneously in various parts of the world. Aid pessimism began to materialize as questions were raised in various quarters regarding the effectiveness of aid in promoting sustainable development. As more questions were raised, cynicism in some quarters ensued arguing that foreign aid amounted to throwing "money down a rat's hole". The triple A phenomenon appears at a crucial time for Africa, where development remains an urgent priority which requires the solidarity of the international community. Again, in the words of the UN Economic and Social Council, "Africa is a test case for international cooperation and development". Because development has not yet succeeded in Africa, it does not mean that we must give up or stop trying. On the contrary, the Secretary-General of UNCTAD said about two weeks ago in Addis Ababa during the Conference of Ministers responsible for Trade, Regional Cooperation, Integration and Tourism, "the world cannot survive in a house divided between rich and poor". During the Ministerial Conference, the UNECA and UNCTAD cooperated very closely in drafting a comprehensive joint African position on various issues to be presented at the forthcoming UNCTAD IX Conference, to be held in South Africa. The African Ministers strongly supported the future role of UNCTAD, particularly in assisting African countries in joint cooperation with UNECA to diversify their economies, mobilize resource flows, and enhance the role of the private sector in development. For a long time, prior to the culmination of the Uruguay Round, many developed countries were manipulating the international trade rules to their own advantage. Developing countries must also learn to use all legally available means and techniques to safeguard their own interests. From the various technical papers prepared for this Conference, it is evident that UNCTAD's expertise in interpreting the new trade rules to defend the interests of developing countries is now more valuable than ever.

UNECA has embarked a far reaching effort to sharpen the focus and outreach of the services that we must provide to our clients, the African governments. We are pushing ourselves to do more with less resources. This requires an even closer cooperation with all of our partners in development to avoid duplication and increase the synergy of our joint efforts, particularly at the country level. As evidence presented during this Conference has shown, the world situation has changed and it will be more difficult to apply the lessons from South East Asia to other developing countries. But, as this Conference also demonstrates, we are not here to lie down and play dead, we cannot afford to stop trying.

This Conference has provided us with rich materials from which to draw lessons. In this regard, I wish to express our appreciation to the Government and people of Japan for facilitating the holding of this Conference, providing us with initiatives such as the Tokyo International Conference on African Development, with inspiration and financial support. ■

Comments on economic policy of Uzbekistan in a new domestic and global environment

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The East Asian development with rapid industrialization together with its integration into the world economy is attracting more and more attention in developing countries, as well as in countries in transition. The experiences of Japan, the first-tier newly industrializing economies (NIEs - the Republic of Korea, Taiwan Province of China, Hong Kong and Singapore), the second-tier NIEs (Indonesia, Malaysia and Thailand) together with China and Viet Nam along this route have encouraged the newly independent states of Central Asia to learn more from them.

Information on countries in transition could provide experts with more ideas as to how to apply knowledge on NIEs to other groups of countries. The aim of my presentation is to help participants at this Conference to become familiar with Uzbekistan with regard to the peculiar internal and external factors surrounding its economic transformation.

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I. Peculiarities of economic transformation in Uzbekistan

Uzbekistan has chosen a gradualist approach to systematic political and economic transformation. This approach was chosen in the light of some aspects of its pre-independence situation: (1) Uzbekistan had the second lowest per capita income among the Central Asian Republics (the third lowest in the former USSR); (2) the rapidly growing population and its high rate of dependency were not favourable in the short-term; (3) net capital flow from all-Union budget, according to the World Bank's estimate, equalled to 19.4 per cent of Uzbekistan's GDP in 1990 (World Bank, 1993); and (4) its economy was over-specialized (dominated by cotton monoculture) and was dependent on the former Soviet Republics for grain, meat and oil. In short, the successful systematic transformation meant to decrease the shocks of disrupting ties with the former Soviet Republics.

Early stage of economic reform (1991-1993). The factors mentioned above explain why Uzbekistan was a member of the rouble zone longer than the other Republics. For more than two years, even after its political independence, Uzbekistan had to follow the macroeconomic reforms in Russia, with all the pains of price liberalization and monetary reforms in the Commonwealth of Independent States (CIS).

The slow and cautious character of the reforms, however, caused less severe disruption in production than had been anticipated. Uzbekistan's output fell less than in any other CIS country. Whereas the CIS average decline was 40.9 per cent in 1990-1993, the reduction in production in Uzbekistan was only 14.4 per cent (see Hasan, 1994). Following strenuous efforts to keep the prices regulated and subsidized at this stage, the government started gradual price liberalization in the fall of 1993. It was no longer possible to allocate the sum equal to 21 per cent of GDP to consumer subsidies and enterprise credits.

Most privatization efforts were directed to small- and medium-sized enterprises (SMEs). As for large enterprises, there were organized joint stock companies mainly as "closed" companies, with the state controlling their shares, despite the fact that the Law on Securities and Stock Exchange, adopted by the Parliament in September 1993, opened the door to trade in shares, bonds, treasury notes, certificates of deposit and bills of exchange.

The foreign trade regime in 1991-1993 did not encourage hard currency exports, though the official, strategy-emphasized export-led growth. Uzbekistan had a multiple exchange-rate system, with huge disparities between official and market rates. The macroeconomic strategy to reduce the shock of disruption by being part of the rouble zone expired by the end of 1993.

New stage of reforms (1994-). On 15 November 1993 the government introduced a new currency, the sum coupon. This was a transitional currency to facilitate withdrawal from the rouble zone, and to centre macroeconomic and monetary policies around Tashkent. The official rate of the sum-coupon was equal to the rouble, but on the free market it depreciated very fast. When macroeconomic policy was in the hand of the Uzbek Government, more attention was paid to comprehensive economic reforms. On 21 January 1994 the President signed a decree, "Measures for Further Deepening Economic Reforms, Providing for the Protection of Private Property and for the Development of Entrepreneurship". Subsequently, the government formed the Interministerial Council on Economic Reform, Entrepreneurship and Foreign Investment, encouraged the creation of organized markets for stocks, real estate and commodity, and established a state insurance company to guarantee foreign investments.

Many consumer subsidies had been abolished by mid-1994. Administered prices and rationing were left for such goods as bread, flour, macaroni, rice, vegetable oil, tea, sugar, eggs, meat, milk and soap, and remained only up to the beginning of 1995.

Targeted credit for wages and the replenishment of enterprises' working capital with a new two-tier banking system were abolished in July 1994. The reserve requirement and refinancing at 250 per cent deprived commercial banks less of the capacity to provide loans.

With the introduction of the permanent currency "sum" on 1 July 1994, the government recognized the importance of right monetary and fiscal policies to control inflation. The credit policy of the Central Bank under a negative real interest rate, oriented mainly to the public sector, was changed sharply in 1994. Hard budget constraints contributed a lot to curbing inflation, from 30 per cent in the first half of 1994 and 15 per cent in the second half, to less than 2 per cent per month by mid-1995. For comparison, the wholesale price hike was about 2,700 per cent in 1992 and 1,100 per cent in 1993. The Central Bank obtained the exclusive right to issue bank notes and coins, and to regulate the use of foreign currencies. It also provides liquidity services and grants licenses to commercial banks for their activities. A two-tier banking system includes today about 30 commercial banks apart from the Central Bank.

The role of the Ministry of Finance is still very important for the financial supervision of enterprises, state budget and fiscal policy. The fiscal deficit in Uzbekistan has been steadily decreasing in terms of the relative size to GDP: 11 per cent in 1992, 9 per cent in 1993, and an estimated 3.2 per cent in 1994. The budget is financed by direct and indirect taxes, gold sales and sales of cotton. The biggest revenue earner is the value-added tax. Uzbekistan did not inherit any external debt from the former Soviet Union. Its own external debt amounted to US$ 700 million in mid-1994 - quite modest but growing. Uzbekistan has good export potential, including a gold production of 70 tons a year. However, it is important to organize proper debt management, especially in terms of maturity structure. During the second half of 1994, the exchange rate regime improved first by unifying cash and non-cash exchange rates, and then in 1995 by unifying official and market rates.

Economic transformation, with sharp internal and external financial shocks and disruption of production ties, has still affected social development. The government has been committed to the policy of social protection. Social and cultural sector spendings accounted for 40 per cent of the budget in 1993 (OECD, 1995, p. 19). According to some preliminary estimates, the real money income of 1994 was almost one-third of that of 1990.

As a result of price liberalization, together with a sharp reduction of food subsidies, the share of subsidies in the money income of the population has declined to one-third during the past two years. The overall reduction in the money income has been accompanied by a more skewed income distribution. According to estimates, at the beginning of 1995 the combined money income of the wealthiest 10 per cent was more than six times that of the poorest 10 per cent. It is less than in Russia (where this ratio was 16.8 times at the beginning of 1995), but the gap is growing.

The reduction in real income - resulting from, among others, the full elimination of consumption subsidies on 1 January 1995 - resulted in sharp changes in the structure of the population's expenditures. The portion of spendings on food, transport, utilities has immensely increased, while that on consumer durables has decreased. It is clearly not possible to retain the old system of social security during the transitional period, but it takes time to reverse the declining trend of living standards and to achieve sustained growth. It is important to start forming a new system under which state protection is given to the most vulnerable and needy people, to cope with transformation shocks by means of pensions for the elderly and other forms of protection for women and children. Providing productive employment - especially new jobs in the growing private sector - to those who are able to work will help to diminish hardships associated with the transition.

Private sector development. The Constitution of Independent Uzbekistan provides equal rights for all forms of ownership. The most important task for the economic reforms in post-socialist countries has been the liquidation of the state monopoly and the formation of a mixed economy through privatization. Uzbekistan refused the idea of impersonal "voucherization", and tried to render property by sale to new owners who can manage it efficiently. As a result, instead of a sharp fall in production and numerous cases of bankruptcy, as have happened in a number of countries in transition, most privatized enterprises have been operating in a relatively stable manner and have overcome the difficulties of the transition period by themselves.

The privatization programme has a consistent character; its implementation was phased in a step-by-step fashion. In 1992-1993, most of the small-scale enterprises and all housing units were privatized. Fifty-four thousand firms were privatized, over 18,000 family enterprises were created, and an additional 1,700 were "closed companies" where the majority of shares are owned by the staff. More than 700 state farms were transformed into collectives, cooperatives and lease-holdings. By the end of 1993, the non-state sector accounted for 35 per cent of GNP. This housing privatization, together with small-scale privatization in trade, services, light industries and agriculture, was very much in keeping with the emphasis on social protection of the population.

In 1994-1995, almost 12,000 enterprises of various sizes were privatized, and their shares openly sold. The government now retains less than 25 per cent of shares in open companies, and employees less than 15 per cent, with no less than 25 per cent available for sale, and also no less than 25 per cent earmarked for foreign investors. As a result, about two million workers have become shareholders and homeowners, three million households have received household plots totalling 550,000 ha, and farmers have taken over 200,000 ha of land.

According to the Deputy Prime Minister, Mr. Chjen, after these two stages, more than two-thirds of the enterprises passed to the non-state sector, and more than 60 per cent of GDP and employment were non-state (Chjen, 1995).

The next stage of overall privatization will concentrate on activities around two major components: one is large-scale privatization (which involves restructuring large enterprises with the broadest possible involvement of the population); the other is post-privatization tasks (including the successful completion of the privatization processes of SMEs). Despite numerous obstacles for their development (underdevelopment of the banking system, complexity of the taxation system, limited convertability of the local currency, etc.), small-scale privatization has gradually been changing the quality of economic life in Uzbekistan, and SMEs have become the most dynamic part of it.

II. First independent steps into the world economy

External finance to support the reforms. Uzbekistan joined the World Bank and International Monetary Fund (IMF) in 1992, and its commitment to reform has begun to appeal to these institutions and the donor community. In early 1995, the Uzbek Government signed a US$ 160 million rehabilitation loan with the World Bank to support privatization efforts, restructure the role of state in marketing and distribution, and reform social safety nets. According to Mr. Parvez Hasan, Chief of the World Bank Regional Mission in Central Asia, this loan could be followed by another quick disbursing policy adjustment operation in 12 to 18 months as post-privatization assistance, i.e. support for restructuring of enterprises. On the investment lending side, the Bank is willing to consider six or seven projects over the next three years, amounting to about US$ 400-450 million. The Bank is especially interested in energy, agriculture and social sectors. It is willing to commit up to one billion over the next five years in support of the government's strong reform programme.

In 1995, Uzbekistan agreed on IMF's Systematic Transformation Facility (STF) programme and received more than US$ 70 million balance-of-payments support. The STF programme and the rehabilitation loan were aimed at reducing the declining GDP trend to 4 per cent or less, and curbing the rate of inflation by 2 per cent or less per month by the end of 1995.

Uzbekistan encountered more understanding of and also support from bilateral donors at the Consultative Group Meeting (Paris, 1 March 1995). In reforming its economy and achieving economic growth, Uzbekistan will continue to need not only financial and technical assistance but also foreign direct investment (FDI).

Foreign Direct Investment. By 1 October 1994, 1,329 enterprises with foreign capital were registered, including 1,234 joint ventures, and 85 subsidiary companies with offices abroad and 10 wholly-owned foreign companies and their subsidiaries. Of this only 586 were in operation. The IMF estimated that net FDI flows amounted to US$ 47 million in 1993 and US$ 87 million in 1994 (for here and below, see OECD, 1995, p. 25). According to existing estimates, FDI in the first half of 1995 amounted to US$ 30 million.

The majority of joint ventures were registered after independence. In 1988-1991, 30 joint ventures were registered in Uzbekistan, compared to 1098 in 1991-1994. More than half of the joint ventures were located in Tashkent city and Tashkent province (770 by 1 June 1994). Many venture partners are from neighbouring regions: Turkey (130), Afghanistan (78), China (70), Pakistan (54) and India (21). However, there are also many partners from the United Kingdom (180), the United States (160) and Germany (30). But very few partners are from other newly independent states.

The joint ventures in 1993 consisted of services (56.2 per cent), manufacturing (41.4 per cent), and agriculture (2.3 per cent). In the first half of 1994, the number of foreign enterprises engaged in manufacturing was growing faster than in other areas. Major investments have also been undertaken in the exploitation of natural resources and the production of soft drinks and cigarettes. Promising areas for investments include: (1) agriculture, with cotton as the major crop; (2) mineral resources, first of all gold mining; (3) the energy sector, oil and gas; (4) telecommunications; and (5) construction and hotels.

It is important to provide a proper locational, economic, infrastructural and regulatory framework to attract global firms. Relatively cheap wages, a good market size, and abundance of natural resources are Uzbekistan's favourable factors. Recent, crucial changes in macroeconomic policies, curbing hyperinflation, unification and stabilization of the exchange rate are also added factors. Poor infrastructures (telecommunications, transport, utilities) inherited from the former Soviet Union are also changing slowly for the better.

The legal and regulatory framework, based on the Law on Foreign Investment and Guarantees for the Activity of Foreign Investors of 5 May 1994, may be considered as rather competitive. However, the tax on profits and high tax rates on wage and salaries are not attractive. To overcome the common tax regime even medium-scale investors are always trying to get special tax privileges in addition to the existing tax facilities, such as tax exemption. A transparent tax with competitive rates would provide more encouragement to foreign capital than the present practice of *ad hoc* privileges.

Foreign trade. Sharp disruption of inter-Republic ties within the former Soviet Union and CMEA led to a decline in foreign trade. Over the period from 1991 to 1994, the turnover of the country's foreign trade decreased by 40 per cent, whereas imports and exports decreased by more than 70 and 58 per cent respectively. This reduction took place mainly at the expense of CIS. The main reasons for this were: (1) the general decline of output and aggregate demand; (2) the transition from the distorted and inefficient structure of inter-Republic relations to the new structure of mutually advantageous exchange of commodities and services; and (3) the new direct horizontal links between enterprises that have not been properly established and the worsened situation caused by the problem of non-payments. Uzbekistan has been able to partly offset these difficulties as it has managed to find new markets for its exports and succeeded in import substitution production of major imports.

In 1993, a trade surplus was achieved as a result of the decrease in imports (especially such commodities as oil and grain). To a certain extent, this was offset by an increase in transportation costs. The balance of payments was also positive in 1994, and by September 1995 the size of official foreign exchange and gold reserves was equal to 5.5 months of imports. The size of foreign debt accumulated by September 1994 was 24 per cent of GDP, and the ratio of debt service payment was 14.5 per cent of export revenues of the first nine months of 1994 (IMF, 1995, p. 33). More than 40 per cent of export revenues came from cotton-fibre exports. And about 40 per cent of imports were energy and food. One half of exports geographically were oriented to former Soviet Republics, and in return these newly independent countries occupied 61 per cent of Uzbekistan's imports.

In 1993, Russia remained the largest trade partner with a share of 61 per cent, following by Kazakstan, Turkmenistan, Ukraine, Belarus, Tajikistan and Kyrgyzstan. The trade balance with other countries - the so-called "far abroad" - was also positive in 1993. Increased exports of gold (in value terms 12 per cent of GDP) and, as mentioned above, of cotton-fibre greatly contributed to it. One half of trade was with industrialized countries and another half with post-socialist and developing countries.

Favourable changes in the world cotton markets, together with a further decrease in oil and grain imports, gave an even better result in its trade balance in 1994. The total foreign trade of Uzbekistan exceeded US$ 3.1 billion in 1994. The IMF programme for that year had assumed a foreign trade deficit of US$ 430 million but, as mentioned earlier, in reality a surplus of US$ 30 million was achieved. Exports performed well in the first quarter of 1995, reaching US$ 557.1 million, which was more than a half of the exports of the previous year. Imports also increased but not to such an extent. As a result, a net trade surplus of US$ 51 million was registered in the first quarter of 1995, against a deficit of US$ 140 million in the last quarter of 1994. The energy sector contributed largely to this improvement, as natural gas exports increased, while imports of oil decreased sharply. Just as in the previous year, a strong increase in cotton prices in the world market permitted to achieve the same amount of currency earnings, even with lower production and exports of cotton.

The disruption of the Former Soviet Union, with its centralized system of foreign trade and state monopoly, required the creation of various institutions in the newly independent states. Within a short period after its independence, Uzbekistan formed new institutions, such as the Ministry for Foreign Economic Relations, the National Bank for Foreign Economic Activity, and the Customs Administration. The strategy was not to lose positions in traditional markets and to expand to new markets. Administrative constraints were decreasing on the basis of gradual approach to trade liberalization.

More than 5,000 firms became participants in foreign economic relations. The National Bank for Foreign Economic Activity quickly established correspondent relations with more than 160 foreign banks. According to the Presidential Decree of 21 January 1994, a unified trade regime was established for all countries in terms of taxes, licenses, quotas. The Ministry for

Foreign Economic Relations is the main body responsible for registration and control of all contracts requiring licenses as well as agreements with centralized delivery. About 60 to 65 per cent of Uzbekistan's trade with other countries is still centralized. Twenty-six items of commodities (oil, gas, metals, cocoons, etc.) require licensing. Nine items are not allowed to be exported from Uzbekistan (flow and grain from state supplies, cattle, meat, oil, dried milk, tea, sugar, spirits and antic items).

By March of 1995 Uzbekistan had 17 trade agreements with the following countries: Armenia, Belarus, Indonesia, India, Iran, Kazakstan, Kyrgyzstan, China, Latvia, Lithuania, Malaysia, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, Estonia. In June 1994 Uzbekistan obtained observer status in GATT and in December 1994 applied for membership to WTO. ■

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Implications of financial globalization for development policy

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It has become common for economists to carry out their analysis of the long-term performance of the economy in real terms. Money and financial issues are usually relegated to short-term effects without permanent impact. However, any discussion of the impact of globalization on policy options cannot ignore the fact that it is the globalization of finance that has proceeded more rapidly and much more extensively than the globalization of trade. In many respects it is global finance that is now the driving force of the globalization process. While it is not an exaggeration to say that there is a global capital market in which most large, developed-country financial institutions operate on a 24-hour basis in all the major national markets, this is not yet true of manufacturing firms, where there is as yet no truly global product market. Nor is there global production, although there are some firms that have started to integrate their production processes and sales on a regional basis. There are two aspects of the globalization of finance that I would like to deal with. The first concerns the globalization of financial services, and the second the globalization of finance itself.

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I. The globalization of financial services

This Conference has looked extensively at the East Asian experience in the areas of manufacturing, and most of the discussion has related to the development of the real economies of the area. The role of the financial services sector in the "East Asian" model of development has been little investigated. As in other areas of economics, the analysis of finance is, I think, rather different from the analysis of the real effects.

The East Asian model has been presented as an expression of the concept of "circulating competitive advantage". This means that there is no process of direct competition for the market share in similar products among the different ranks of the gaggle of flying geese. The country which advances does not compete its way into a market by beating out existing producers; rather, it moves into a market that is being vacated by a slightly more advanced economy that no longer finds the market profitable at its now more advanced stage of development. This decision to shift into markets higher up the added value and/or technology scale may be due to changes in relative factor costs, or accumulated knowledge and capital. Thus, the ranks of flying geese can all move forward without the advance of any one goose being to the detriment of the position of another.

The natural evolution of countries through the stages of production of financial services does not appear to work in this way. The reason why can perhaps best be seen by reference to Professor Rowthorn's revised version of the flying geese model presented earlier. To summarize briefly, the argument is based on the idea that Japan did not in fact play the role of the "lead goose" in promoting Asian development, basically because it was primarily concerned with building its markets in the United States. Indeed, the United States tended to play a larger role as an export market for the rest of the East Asian geese than did Japan. Further, most Japanese investment in this period was domestic, not foreign direct investment (FDI) in East Asia; and when Japan did start to invest abroad on an appreciable scale, it was in the United States and to a lesser extent in Europe. However, after the gaggle of Asian geese (the first of which were in fact flying tigers) was airborne, Japan did eventually assume the lead position at the point of the flying V, but this was only after the two wings of the V were well-formed and the development process was well underway. This was at about the time that Dr. Akyüz's (1996) paper identified Japanese investment as shifting from complementary to substituting for Japanese exports. Again, exports went primarily to the market of the United States.

This was the point at which it became clear that Japan could no longer count on the United States as the surrogate lead goose, both for Japan and the rest of Asia, as far as the provision of ever-growing export markets were concerned. But, as Professor Jomo (1996) notes, when Japan did take a more active interest in the development of South East Asia, it was not so much to recommend that these countries take up those markets where Japanese producers were encountering difficulty, and to build up their own domestic industrial capacity. Rather, it was suggested that since Japanese firms were more efficient they could organize the local production capacity on the basis of Japanese capital and management. It is for this reason that Professor Rowthorn (1996) views the future of South East Asia as one of regional integration based on FDI, rather than on strong linkages in trade. But this version of the flying geese model is no longer based on circulating comparative advantage and complementarity; it is one of negotiated confrontation, at least as between domestic production and Japanese FDI providing foreign-based Japanese producers.

This model has been primarily applied to the explanation of the development of exports of manufactures. But when we deal with financial services, the complementarity of circulating comparative advantage seems to be less applicable. For example, there does not seem to be the same evolution of production, such as Professor Rowthorn has represented in his Chart, for services. We cannot talk about a country targeting labour-intensive banking services in the same way that we would talk of targeting the market for, say, textiles, and then allowing these to be taken over by the next rank of geese, as the country moves up to a higher level of financial services that has been vacated by the lead goose. It is extremely difficult for a country to use cheap labour to provide a comparative advantage in banking and financial services (although some auxiliary processing and ancillary services may be in this category). High technology not only requires highly skilled labour, but it also requires a strong capital base and rather sophisticated infrastructure technology.

If trade in financial services is open, the sector will eventually be dominated by the lead goose, now and in the future. There will be little possibility for a country to move up the ladder into vacant sectors to achieve a higher level of value added in financial services. As in the Japanese approach to manufacturing in the region, the approach is to let the developed countries' financial services companies provide the lead in the developing countries' financial sector, since they are so much more advanced and therefore more efficient. Thus, the opening and liberalization of financial services is unlikely to behave according to the traditional pattern of the flying geese model.

Unlike the conditions in the 1920s when financial systems were exported from the developed to the developing countries, it is currently not likely that the financial system of the lead goose will become the dominant system in any single country or in the region as a whole. Financial liberalization and opening means leaving the decision as to the financial structure of the economy to international competition for the domestic financial services market. One of the forces behind the internationalization of finance has been an avenue of escape from domestic financial systems. For example, both American and Japanese banks are allowed to engage in areas of activities which are precluded to them under their domestic regulations. Thus, somewhat paradoxically, developed country financial institutions will probably be very keen to ensure that their home country financial structures are not exported to the foreign countries in which they operate.

However, the decision over the financial structure, as it pertains to the regulations governing the operation of financial institutions, is one that is within the power of government to legislate and control foreign entry via the application of prudential regulation. German banks complain that they are discriminated against by United States regulations because they have restricted banks from opening branches and from operating in securities underwriting, both of which they could do in their home markets, and as American banks operating in Germany could do. Prudential banking regulation in the United States has thus limited expansion of foreign banks, and also protected a particular financial structure based on segmentation of banking and financial institutions by their function. It has never been suggested that this has been an impediment to trade or represented restrictive trade practices. The result is that in the area of bank regulations the concept of national treatment has been developed to represent equivalent market access. This means simply that a country is free to set any prudential regulation that it feels is necessary for the integrity of the domestic financial system, but must apply those regulations equally to domestic and foreign entities. Sovereignty over the determination of prudential regulations thus remains open to developing countries, irrespective of the conditions governing trade in services which might be contained in any international treaty.

However, there are cases in which international agreements may constrain local determination. An example is the Basle Agreement on risk-based capital requirement applied to banks operating internationally, and which has now been applied to most domestic banking operations. But when these constraints have arisen, they have been adjusted by the margin of negotiation in the requirements that allows a country to implement them in ways which are compatible with its domestic financial structure. For example, in countries such as Japan where banks hold substantial unreported gains on investment securities in hidden reserves, a more generous contribution to bank capital was allowed for the unrealized gains on portfolio investments. Thus a basic characteristic of the structure of bank operations in Japan which would have been compromised by the strict application of international regulations was amended to preserve the existing financial structure.

It has been suggested that the Basle requirements were engineered by the United States in order to facilitate the marketing of government debt. The zero weight applied to bank holdings of government debt grants an implicit subsidy to government borrowers when government debt is currently no less risky than that of many private borrowers whose debt carries a 100% weight. But, there are other lessons to be learned from the United States which might allow for the use of domestic regulations to provide support for the use of directed lending, such as that which was discussed earlier during the session on marginalized sectors.

The concept of a "government agency" was created under the Roosevelt Administration to apply and enforce New Deal economic programmes and regulations. Since some of these programmes required directed expenditures, they were given the ability to borrow. But since their expenditure was not directly required for the operation of the government, their borrowing is not classified as government expenditure; it is classified as "off budget". However, the securities issued by government agencies are considered to be equivalent to United States sovereign debt, and are thus classified at a zero-risk weighting for the purposes of calculating risk-adjusted bank capital on the Basle standard.

Some of these United States government agencies are close equivalents to what would be called development agencies, and provide finance at preferential rates for housing, agriculture, education and so forth. This means that such lending benefits from a de facto subsidy because, first, it is given the same zero-risk credit classification as United States government debt and, second, because it qualifies for the zero risk-weighting for bank capital, both of which reduce the interest rates payable on the debt. At the same time, the risk-weighting for multilateral development banks (such as the European Investment Bank) is set at 20 per cent by the Bank for International Settlements (BIS). There is no reason why developing country governments could not avail themselves of the same possibilities as the United States Government in providing preferential interest rate funding for directed financing. In this way, a similar effect to that achieved by direct interest rate subsidies could be produced through the BIS regulatory structure.

Thus, there should be no impediment to the use of both domestic and international prudential regulations to preserve a certain autonomy in the development of domestic financial institutions and the use of finance to direct the process of development.

II. The globalization of finance

The second point relates to the role of financial flows themselves on domestic policy autonomy. The problems which may be caused for developing countries by capital flows have been highlighted over the past 20 years. The basic lesson is that too much (as in the 1970s) is just as bad as too little (the 1980s), and what is even worse is passing rapidly from one to the other (the 1990s). These general lessons have given rise to some particular propositions for developing country borrowing. Not all of them seem to be soundly based.

The first, in response to the expansion of syndicated bank lending to sovereign countries in the 1970s is that bank borrowing should be avoided. Better to use non debt-creating borrowing. This seems to be an oxymoron. Nonetheless, the idea has been built up that private portfolio investment and FDI are preferable to bank lending because they do not have a foreign currency denominated fixed interest charge determined by international capital market interest rates.

Recent experience with the volatility of portfolio flows has also led to doubts about the benefits of this type of borrowing relative to FDI, which is now considered as the preferred alternative as the basis for foreign capital support for the domestic growth process. This impression is supported by the reference to the Asian development process which has been largely free from the problems relating to excessive capital flows. The idea has thus grown up that FDI is the most appropriate form of foreign borrowing because, as mentioned above, it does not have the fixed interest element of bank debt and it does not have the volatility associated with portfolio investment. This is basically because FDI is considered to be investment in domestic bricks and mortar that cannot easily be moved.

This seems to be another example of the difference between analysis of the real factors and of the financial factors in the economy. First, consider the distinction between portfolio investment and FDI. The distinction was initially created in order to distinguish between foreign and domestic control of productive assets. The presumption was that investment for the purpose of control would be of a more or less permanent variety. The concern over excessive FDI was a policy concern to the effect that if government imposed domestic policy restrictions to remedy the balance-of-payments crisis, foreign owners might simply choose to avoid them by closing down and walking away. Concerns of this sort were common in Europe in the 1960s. But, they are quite different from the kind of policy concerns of most developing countries today. The official definition of FDI thus has nothing to do with its permanence or mobility or its volatility. Indeed, it seems to ignore the facility with which developed country investors obtain and discharge control of companies through mergers and acquisition markets. In current financial markets companies seem to have become commodities which are traded daily in markets for corporate control.

But even if FDI were redefined so as to include only investments in immobile bricks and mortar deemed to be of a permanent nature, would that mean that FDI would have a different impact on capital flows and exchange rate management? I think that the answer is no. This also relates to the globalization of finance.

Recent innovations in financial markets have gone a long way towards eliminating the concept of a permanent investment or the "maturity" of an investment. An investor in a 30-year bond used to be considered as a long-term or permanent investor holding a long-term asset until maturity. But financial engineering has shown how a 30-year bond can be re-engineered to produce (a minimum of) 61 zero interest rate bonds with maturities ranging from 6 months to 30 years. He may be a purchaser of some or all of them, or may buy and sell components to produce an instrument which has any number of different possible cash flows and maturities. To reduce his long-term position, and thus the permanence of his investment, he certainly does not need to sell the original bond.

In addition, the availability of futures and options contracts provide other alternatives which allow the investor to retain ownership of the bond, but to reduce the permanence of investments as well as exposure to market risks, such as changes in interest rates or exchange rates. Now, if this is the case for a 30-year bond investment, it will not be different for foreign portfolio investment. And this will also be the case for FDI. The investor can continue to own the bricks and mortar without retaining the foreign country risks, foreign exchange risks, and so forth, associated with their permanent nature. As there may be sceptics on this point, the investor may refer to an unimpeachable source, a recent World Bank study which notes that: "Because direct investors hold factories and other assets that are impossible to move, it is sometimes assumed that a direct investment inflow is more stable than other forms of capital flows. This need not be the case. While a direct investor usually has some immovable assets, there is no reason in principle why these cannot be fully offset by domestic liabilities. Clearly, a direct investor can borrow in order to export capital, and thereby generate rapid capital outflows" (Claessens, Dooley and Warner, 1993, p. 22).

The methods available for hedging the risks of any investment, including FDI in bricks and mortar, do not usually lead the investor to engage in any direct foreign exchange or a capital market transaction. However, they will almost always require the financial intermediary to do so at some point in time. These flows will usually be greatest when uncertainty over the exchange rate or domestic financial conditions is greatest. It is thus simply not the case that, since it is difficult to find a buyer for a bricks and mortar FDI at short notice, they will not produce the same types of financial flows as portfolio investments. Home country firms keep their balance sheets in their domestic currency, and foreign investments represent currency risks in the same way as any other use of company funds. This means they will also be hedged in the same way as investments in real productive assets, which does not mean that the foreign currency translation risks and funding risks will be ignored. To the extent that risks are covered, they will produce cross-border flows, which will produce pressure on the foreign exchange market or the domestic money market.

Indeed, this point is made in a slightly different way by the World Bank study referred to above, which notes that "long-term flows are often as volatile as short-term flows, and the time it takes for an unexpected shock to a flow to die out is similar across flows" (op. cit. p. 26). The study concludes that in general it is impossible to differentiate statistically between portfolio and FDI capital flows. Part of this result is, of course, due to the way FDI is classified, which can include a wide range of financial investments which are not in any way related to bricks and mortar investments. (A classic example used by every teacher of international monetary theory is the international exchange of a 30-year bond with one year to maturity which is classified as a long-term capital flow.) But, it also highlights the fact that in the presence of the globalization of finance, all investments have become liquid and all investment will be hedged to some extent.

There is another aspect of FDIs which is usually overlooked when it is argued that they are preferable to bank loans because they do not generate interest flows. The presumption is that since there are no prearranged interest payments, no payments will be made to foreigners. Yet, foreign direct investors do invest with the expectation of being repaid, with profit. For a developing country, FDI is not an unconditional gift; it is a loan made against the expectation of profit earnings and the possibility of repatriation. Now, from the point of view of the lender of funds, the risks associated with bank-syndicated sovereign lending are the lowest, risks of portfolio investment higher, and those associated with FDI the highest. In fact, this is partially related to the fact that these investments are more permanent and thus less easy to hedge. But it is also due to less perfect information, the difficulties associated with operating in foreign cultures and the simple factor noted by both Smith and Ricardo that investors will have a preference for keeping their investments at home, where they can keep an eye on them. ("Experience, however, shews, that the fancied or real insecurity of capital, when not under the immediate control of its owner, together with the natural disinclination which everyman has to quit the country of his birth and connections, and intrust himself with all his habits fixed, to a strange government and new laws, check the emigration of capital. These feelings, which I should be sorry to see weakened, induce most men of property to be satisfied with a low rate of profits in their own country, rather than seek a more advantageous employment for their wealth in foreign nations" - Ricardo, 1951, pp. 136-137.)

Thus, the risk premia attached to the returns on lending will be the highest for FDI. This means that FDI is the most costly method of borrowing capital for a developing country. Indeed, most international companies carrying out FDI have hurdle rates of return in the range of 10 per cent. It is paradoxical that developing countries are told that FDI is the least risky form of foreign borrowing, when from the point of view of the foreign lender it is considered the most risky. If the risk is borne completely by the foreign lender, then compenzation will be expected in terms of an appropriately high rate of return.

This leads to another, often overlooked, aspect of FDI. As seems apparent from FDI statistics, in most countries which have benefited from foreign investment, the greatest proportion of FDI is comprised of the reinvestment of the profits on foreign investments. One of the basic reasons why FDI is considered a more attractive form of foreign borrowing than, say, bank borrowing is because it does not produce a fixed or immediate charge on foreign exchange reserves. However, profits nonetheless represent a claim on reserves, for they are recorded as current account outflows which are balanced by an automatic offsetting entry in the capital account representing the reinvested earnings as an FDI capital inflow.

In a sense this is the equivalent of capitalizing the interest on a loan, and simply shifts the claim on foreign exchange reserves into the future. While the recipient country may consider these reinvestment flows as the equivalent to direct investment, the investor may consider them as a delayed return on the original investment, and they need not be invested in productive enterprise, but may easily be invested by the foreign-owned subsidiary in liquid domestic financial assets. Thus, although they are recorded as FDI flows, they are the equivalent of short-term portfolio investments in both fact and intention. This can make it very difficult to assess the real condition of a country's balance of payments, for they can create the bunching of the repatriation of earnings, creating disruption in the foreign exchange market.

Balance-of-payments conditions may be further complicated if FDI flows finance investments in productive facilities requiring a large proportion of imported specialized capital goods and specialized semi-finished goods for domestic assembly. These imports may be offset by the creation of additional exports or re-export of the assembled finished goods or by the recorded reinvestment of profits. But, they may give rise to a net drain on reserves since FDI flows do not represent actual foreign currency inflows or foreign receipts may be used to meet the claims of foreign investors, while imports will always give rise to claims on foreign currency reserves.

Of course, the most important aspect is that related to the reinvestment of earnings from FDI. Just as any Ponzi-type scheme, it works as long as the reinvestment continues and foreign investors are willing to take their profits in terms of increased domestic investment. Problems occur when the inflows are not sufficient, or when the foreign investor decides to reallocate capital to an alternative investment location. It is here that the wonder of compound interest plays a crucial role. At an annually compounded rate of return of 10 per cent, investment value doubles in a little over 7 years, at 15 per cent it doubles in under five years, at 25 per cent it doubles in just over 3 years. A country with a tiger-like growth rate of 10 per cent per annum and an one-time net FDI inflow of 10 per cent of national income would find itself with an accumulated stock of FDI equal to national income in under 18 years if the domestic return on the investment is 25 per cent per annum. If the return is 20 per cent, the same result occurs after 26 years. If the return is 25 per cent but the domestic growth rate is 7.5 per cent, then the same result occurs in 15 years. This is without any FDI except the reinvestment of earnings on the original stock. Thus, by the end of the period of 18 years, foreign claims with respect to profits would be equal to 25 per cent of GDP.

On the other hand, if new FDI remains at 10 per cent of GDP, so that it grows in step with GDP, then the accumulated FDI stock reaches 100 per cent of GDP in around 10 years. This rate of accumulation of FDI is roughly equivalent to the annual increase in FDI stocks reported for Malaysia between 1983 and 1994.

Aside from any other issues, if we assume that the country has settled into an equilibrium on its external accounts that accommodates this FDI inflow, a structural instability is built into the system. This can be seen from two possible scenarios. In the first, a crisis may be generated without any necessity of capital outflows through the sale and expatriation of capital invested in bricks and mortar. It is sufficient for a domestic or international capital market event (recall the outflows of Japanese capital from the United States after the collapse of the bubble at the end of the 1980s) to cause foreign investors to stop their FDI inflows. Just as a modern bank run, which occurs not because depositors withdraw their funds but because lenders refuse to renew their loans to the bank, a developing country which has adjusted to the permanence of FDI flows will be increasingly exposed to a chance interruption in those flows, which is completely independent of the permanence of the previous flows embodied in the existing stock of FDI.

In the second scenario, let us assume that foreign investors decide that when the ratio of FDI stock to GDP reaches 100 per cent it would be prudent to start to reduce their exposure and repatriate 50 per cent of the annual profit flows. Again, without any necessity to liquidate current holdings, this would mean that additional annual export earnings of 12.5 per cent of GDP would be required to service the foreign lending, irrespective of imports. It would also mean that the export surplus would have to expand more rapidly than the domestic growth rate if an exchange crisis were to be avoided. This is clearly unsustainable, both in terms of the share and the rate implied. The share and the rate of increase in the export surplus which would be required to support even a 25 per cent profit repatriation ratio would be unsustainable unless the net contribution of FDI to exports were equivalent to profit repatriation.

These are the sorts of structural impacts which excessive reliance on FDI flows may produce on the payments flows of the economy and highlight the similarity to a Ponzi scheme of FDI flows based on the high reinvestment of profits. The structural instability that arises is independent of any short-term instability of FDI flows due to the financial innovations mentioned above and would arise even if FDI were as permanent as is traditionally supposed.

Unless FDI flows are truly permanent, in the sense that neither profits nor principal are repatriated, the more successful a country is in attracting FDI and the more successful that FDI is in terms of generating returns, the more fragile will be the country's current account position and thus its exchange rate. But both of these factors will increase the currency risk of the FDI and lead to the increased probability of repatriation or hedging through the foreign exchange market. If success also raises domestic incomes and costs, thus reducing domestic rates of return, this will reduce the size of FDI reinvestment flows and take pressure off the current account, but it will also lead to greater attraction to shift investments to other locations, and thus to much more massive shifts in invested capital.

Developing countries may therefore find themselves in a position which resembles that of the United States in the 1960s with respect to its gold reserves. European countries had built up large investments in dollar reserves on the understanding that they were convertible into gold. But the outstanding dollar claims soon exceeded the United States gold supply. The United States balance-of-payments accounts were redefined several times in order to better reflect the potential pressure on the gold-value of the dollar by trying to assess the "permanence" of foreign claims, and thus the likelihood that they might be converted into gold or foreign exchange and cause a collapse of the dollar. Some of the claims were clearly of a long-term nature and represented no risk of being converted, while others could be converted quickly. Most holders recognized that it was in their interest to continue to hold dollars, for any single holder's attempt to convert would trigger a mass of sales and a large capital loss on their dollar holdings if gold convertibility had to be suspended. Nonetheless, in the end, even permanent claims started to be exercised and the result was a collapse of the dollar and the suspension of gold convertibility.

The problem for a developing country is to assess what proportion of FDI flows are indeed permanent, and what their short- and long-term impact on trade flows will be. It is probable that the higher the return on investment and the higher the proportion of reinvested earnings in total FDI stock, the less permanent the FDI stock will be, and thus the greater the threat to the balance of payments and to exchange-rate stability. In this respect the choice between FDI and other types of foreign borrowing is one of degree rather than difference, and the amount of foreign investment, whatever its nature, cannot be a matter of indifference to government policy.

Thus, while portfolio flows may have a more direct impact on short-term reserve management and exchange rate policy, FDI may have both a short-term and a more long-term structural influence on the composition of a country's external payments flows. While financial innovation allows FDI to have an impact in the short term which is increasingly similar in terms of volatility to portfolio flows, the more important aspect is the way it may mask the true position of a country's balance of payments and the sustainability of any particular combination of policies. Just as accumulated dollar claims on gold represented a Damocles sword hanging over the gold-dollar exchange rate, accumulated foreign claims in the form of reinvested profits may create a potentially disruptive force, which can offset any domestic or external policy goals. During the 1960s and the 1970s, it was common for countries, such as Germany, to place direct controls on capital inflows, just as it was common to regulate the raising of capital in domestic markets by the United States, Switzerland, Holland and other developed countries. Current conditions do not suggest that developing countries should be prevented from using the same types of regulations to protect their domestic and external stability. ■

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Session 5

POLICY LESSONS

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Lessons from the East Asian experience

Yilmaz Akyüz[*]

I. Introduction

During the past two decades, the economic performance of Japan and a small group of East Asian countries, including the Republic of Korea, Taiwan Province of China, Hong Kong and Singapore (collectively identified as the first-tier newly industrializing economies - NIEs), has attracted considerable attention. This experience of industrialization, which appears quite unprecedented in history, has begun to have a profound impact on economic policy debates outside the region, particularly after the difficult international economic climate in the 1980s. Countless academic works, official reports and newspaper articles have been produced describing the industrialization of these countries and discussing whether others can learn from this experience.

Initially, this experience was seen by most Western observers primarily as a case of market-oriented industrialization. However, further research over the past decade has directed attention to the policies that supported an impressive pace of capital accumulation. As a result, the simple free market interpretation of the East Asian experience no longer enjoys wide support, and there is a growing consensus on the positive contribution of the state to the region's success.

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With convergence around these broader issues, the debate has shifted to the impact of certain heterodox policies practised in East Asia and their suitability for other countries operating under different domestic and international conditions. Increasing attention is now being paid to whether other developing countries, including other countries in the region, have the structural and institutional prerequisites to succeed with similar policies, and whether these policies are still relevant in today's world economy.

While strong economic performance suggests a shared experience among countries in the region, there has been a growing awareness of differences in the specific policies and institutions used to accelerate industrialization and achieve rapid economic growth. Indeed, it is only natural that institutional adaptation and innovation in the industrialization process make it inevitable that different countries embarking on development at the same point in time end up with different institutions and policy mechanisms, even if they follow a broadly similar strategy. Thus, there is, in principle, no contradiction between acknowledging differences among the East Asian countries and the search for common principles in their experiences. In what follows I shall concentrate primarily on the three major countries in the region, Japan, the Republic of Korea and Taiwan Province of China, because their experiences are more relevant for most other developing countries than the two city-states (Hong Kong and Singapore).

There can be many ways of characterizing these common principles and lessons. I would like to discuss them under three headings: (1) the development strategy; (2) policy design and implementation; and (3) institutions. I will briefly comment on these topics, which are further elaborated in our report to this Conference and in other papers.

II. Development strategy

There can be little doubt that any long-term rise in living standards can only be achieved through sustained productivity growth. The East Asian countries saw a rapid pace of capital accumulation as the central element of the development process; rising investment was a vital prerequisite, if not a guarantee, of rapid productivity growth. This required mobilization of resources and creation of modern business corporations as the vehicle for capital accumulation. Furthermore, disciplining business was seen to be necessary for efficiency and good investment. Finally, promotion of the interests of the business sector should be consistent with national interests; not to be done by redistributing a given income away from other social classes, but by creating new wealth through accumulation and productivity growth. No social class was to be excluded from development or allowed to be marginalized. The development strategy thus appears to have been standing on three legs.

A. *The investment-profits nexus*

First of all, the East Asian governments tried to guarantee certain basic conditions for investment by local business by means of maintaining political stability and creating a "pro-investment" macroeconomic climate. A pro-investment environment is a better description of East Asian macroeconomic policies than a stable one, because some of these governments were willing to tolerate a fair degree of inflationary pressure for the sake of boosting investors' confidence. Moreover, consumption rather than investment was sacrificed first when more restrictive measures were seen as necessary to balance national economic goals.

Secondly, strong incentives were provided to encourage investment by introducing measures to boost profits above their free-market levels. This was done in two ways. A range of fiscal instruments were used to supplement corporate profits and to encourage their retention in order to accelerate capital accumulation. Trade, financial and competition policies were also used to boost profits and therefore the potential resources available to corporations. As a result, corporate savings came to play a particularly important role in capital accumulation. A large part of value added went to profits, but a very large proportion of these profits went to investment.

There was no guarantee that resources channelled to business would be used for productive investment. Thus, measures were taken to close off channels for unproductive, speculative investments and capital flight, and to restrict luxury consumption.

Together, this mixture of incentives and restrictions created and sustained a dynamic *investment-profits nexus*; high profits increased simultaneously the incentive of firms to invest and their capacity to finance new investment, higher investment in turn raised profits by enhancing both rates of capital utilization and the pace of productivity growth.

The investment strategy was to ensure that the rich did not spend their wealth on their own enjoyment, but on investment. Consequently, unlike many other developing countries, an economy based on private corporations and profit motive was never really in question, no time was wasted with debates over capitalism versus communism, and indeed communism never became a serious alternative. Investment and growth provided the social justification of placing a large part of income in the hands of the capitalist class, and constituted the basis for continuous improvement in the daily condition of the mass of the population.

B. The export-investment nexus

However, the challenge of economic development does not end with high levels of investment. Even if all the mobilized resources are invested productively, there is still ground for asking whether they are being invested in the "right" areas. In this respect, an important feature of East Asian development has been efforts to link the investment-profits nexus to the export-investment nexus. Firms were encouraged to export and compete in foreign markets, which exerted an important discipline over enterprises, thereby promoting efficiency. This was preferred to exposing firms to foreign competition through import liberalization.

However, the principal rationale for the strategy of export-oriented industrialization that the first-tier NIEs pursued has been different. Initially, they had no significant capital-goods sector and produced mainly consumer goods. Exports, together with some limitations on imports of consumer goods, allowed the domestic industry to expand without a corresponding growth in domestic consumption, thereby helping to raise domestic savings. They also provided the foreign exchange needed for capital goods imports and access to advanced foreign technology as part of the strategy of catching up based on imitating technology leaders. While success in raising savings and investment depended crucially on export growth, export expansion required new investment. Thus, rapid growth required mutually reinforcing dynamic interactions among savings, investment and exports.

But the evolution of an export-oriented industrial sector is neither spontaneous nor without difficulties. Given the relative paucity of natural resource endowments, it was apparent from an early stage that there were serious limits to resource-based industrialization. Concerted effort to develop labour-intensive manufacturing industries for export was therefore made from the beginning. Although these countries enjoyed a comparative advantage in labour-intensive manufacturing, this did not mean that investments in these industries were automatically forthcoming. In most cases, they still needed government support.

However, what distinguishes the export-investment nexus in first-tier NIEs from other developing countries is that from the early stages of their industrialization they anticipated the future difficulties that static comparative advantage industries would face, including rising wages, limits to productivity growth and to demand expansion in the world market. They gradually and purposefully nurtured new generations of industries with greater potential for productivity growth in the long run. They went for acquired comparative advantage via selective industrial policy, using a number of instruments to support and protect infant industries. Industrial policy guided successive generations of more advanced industries, to bring about upgrading that would not have happened spontaneously or rapidly through the market mechanism in the absence of state intervention.

C. *Equity and participation in development*

An important element of the strategy was to reconcile rapid growth with equity. Although profits accounted for a high share of value added, this did not result in a large inequality in personal income distribution, because profits did not constitute an important part of personal incomes. They were retained as business savings and invested.

Integration of the marginal sectors was not simply looked upon as a welfare state objective. It was an integral part of industrialization and development because of various linkages and impulses such sectors could potentially create for the entire economy. Thus, support was given to small producers both in the rural and industrial sectors through targeted public investment, subsidized credit and advisory services. There was also an effort to link small producers to large firms and public research institutes in order to support industrial upgrading.

III. Policy design and implementation

Building an export-investment nexus alongside a strong investment-profits nexus has not involved any unfamiliar policy instruments. Almost all policy instruments applied in East Asia have also been applied in some other parts of the developing world. What distinguishes East Asia is not that they have been more innovative in developing policy tools, but more effective in applying them.

A. *General principles governing policy design and implementation*

Selective intervention: There was no attempt to intervene all the time in all aspects of economic life. Intervention in some areas was combined with liberal policies in others. High protection and support for infant industries was combined with low protection and support for the mature industries.

Preventing market failures: The approach often favoured preventing failures rather than dealing with their consequences. Market failure was not defined in relation to an abstract notion of efficient allocation of resources, but rather in relation to the ability of the market mechanism to achieve specific development goals set by the government.

Focused objectives: Policy instruments were assigned specific and well-defined objectives, often within a time frame, rather than general and abstract developmental objectives. This was essential for assessing their effectiveness.

Pragmatism: Care was taken not to promote policy instruments to the status of ultimate objectives. There was no obsession with instruments. When an instrument was not effective, its orientation was changed, or it was abandoned and replaced by more effective ones.

Reciprocity: Support and protection provided to private business were based on reciprocity. They were designed essentially as a "pump priming" exercise, to be eventually withdrawn. Thus, businesses was expected to eventually prove themselves by the standards of the international market. This required imposing implicit or explicit performance criteria (such as export, investment or productivity targets) on the recipients of the support.

B. Integration with the international economy

Strategic integration: The East Asian experience shows that an active and fruitful participation in the global economy requires a deliberate approach to international integration. A measured and properly sequenced set of policies towards trade, finance and FDI, and a strategic approach to liberalization remain a key to success in the global economy.

Selectivity and sequencing: The strategy pursued in East Asian countries involved opening up different sectors of their economies to foreign competition in different degrees, according to their national policy objectives and the level of development reached. In general they were relatively open in trade, except in "strategic" industries and luxury consumption goods; more restrictive on technology licensing; much more restrictive on foreign direct investment, except in certain export-oriented labour-intensive industries; and extremely restrictive on capital flows, until their economies attained relatively high levels of development. The differing degrees of openness in different areas was not simply an accident, but determined by their long-term industrial strategy, which put emphasis on channelling the available surplus into productive investment, supported by attempts to develop domestic technological capabilities.

IV. Institutions

Effective implementation of the development strategy and policies in East Asia depended crucially on building appropriate public and private institutions. Three such institutions stand out: a strong, meritocratic bureaucracy; institutions designed to provide strong links with the entrepreneurial classes to assist in the design, implementation and coordination of policy; and a corporate structure conducive to investment.

A. *Bureaucracy*

A substantial degree of insulation of core bureaucracy from political pressures: Total insulation is neither possible nor desirable (it can bring inertia), but if the bureaucracy is unduly subject to the pressures of day-to-day politics, it will be less able to devise and modify policies in the light of its own learning. It is also more likely to become overburdened with multiple objectives.

Continuity of civil personnel: While too great an emphasis on continuity has its dangers (encourages aversion to new ideas), only part of the technology of policy-making can be embodied in organizational structure. Much will depend upon the accumulated knowledge embodied in civil servants, which requires continuity.

Meritocracy: Insulating bureaucracy and preserving continuity may be necessary for the accumulation of policy experience, but this will not be adequately digested if the quality of the personnel is low. Encouraging strong organizational goals and loyalties by recruiting from top educational establishments, promoting from within and providing attractive remuneration.

B. Government-business relations

Formal and informal links with peak business organizations: The main objective of these links was to assist in the design, implementation and coordination of policy measures. Close and good working relationships with the private sector also allowed the bureaucracy to acquire more detailed information about the private sector capabilities and shortcomings. It also helped to avoid market failures in attaining development objectives.

Sectoral ties: However, the core efforts of institutional design have been through formal and informal ties created at the sectoral level. Sector-specific consultative agencies have often taken a lead role in enhancing the transparency and fairness of administrative decision-making; forcing decision makers to clarify and justify their actions; facilitating information flows and providing a forum for solving conflicts and coordination problems that characterize economic policies.

C. Corporate structure

Large, diversified business groups: As already noted, an important feature of the Asian success rests at the firm level. Large diversified corporations (private or public) have been a prominent feature in most East Asian economies. These firms have been able to establish a pattern of corporate governance which has not been pressured by short-term profit goals and has successfully coordinated activities across a number of industries.

Links between industrial firms and the financial sector: Strong links between finance and industry has served to promote productive investment. The bank-based financial system prevalent in East Asia (as opposed to Anglo-American market-based financial system) has provided various mechanisms to overcome obstacles to investment, such as high risks arising from information and coordination problems. It has also facilitated government-business collaboration and policy intervention at the corporate level.

V. Question of replicability

It is important to bear in mind that the lessons from this experience cannot be drawn in a mechanical way. At any moment in time, each country faces a unique situation which depends on a host of factors, including its size, level of development and past history, as well as on the state of the world economy, which is in constant flux. Thus the search for lessons from a successful experience should not be guided by a desire to clone the experience elsewhere - as it clearly cannot.

Indeed the success of East Asia can, in part, be linked to special conditions that are unlikely to be repeated elsewhere. However, when one looks closely enough at any successful (or indeed unsuccessful) development experience, one can always find such conditions. For example, the North American development experience, which is often contrasted with that of East Asia, benefited from exceptional natural resource endowments, the large size of its domestic market, and the inflow of a large number of skilled immigrants, none of which are likely to be found in today's developing countries.

It is clear that there is no single path to development which fits every country, or even the majority of countries. However, recognizing this institutional diversity should not be confused with the argument that there are therefore no lessons to be learnt from the East Asian experience. As attempted above, it is both possible and instructive to identify some major common principles that underlie this successful experience, and try to adapt the policy tools and institutional vehicles that were used to realize those principles in order to fit local conditions elsewhere, and if necessary to devise new policy tools and institutions. Indeed, if East Asian governments had themselves believed in the impossibility of such institutional adaptation and innovation and had ignored earlier success stories, it is doubtful whether we would have an East Asian miracle to discuss. ■

Comments on policy lessons from East Asian development

*R.C. Duncan**

After reading and listening to the arguments about the vital importance of the apparently extensive government interventions in the sustained economic growth of the newly industrializing economies (NIEs), I ask myself "Why then did the Soviet Union fail?" It had the highest per capita physical and human capital accumulation of any country and the most extensive government intervention. While it grew at rapid rates for several decades, eventually its marginal productivity of capital was driven to zero because the human and physical capital was misallocated, and growth ceased.

Obviously then, if an important ingredient in growth is not government intervention *per se*, it must be only certain kinds of intervention. We are urged to believe by most of the background papers that the important interventions were "corrections of market failures" of all different kinds, but with asymmetries of information figuring largely among them.

I am generally of the view that there are not numerous, important market failures "at large", because finding a way to internalize a market failure provides an opportunity for some genius to earn huge amounts of money. But correcting a market failure in a country is basically a job for its government, to be achieved through creating appropriate private property rights and enforcing the contracts made in the exercise of such property rights. Situations where it is impossible to create private property rights are called "public goods", in which case the government has to provide the service.

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What I see as the main functions of the government, aside from welfare activities, are the creation and enforcement of property rights to assist markets to function and the provision of public goods. Much of the government intervention discussed here approvingly as "correcting market failure" refers to situations where the government undertook the activity itself rather than looking for ways to make the market work. Government actions may indeed have been effective. They may even have been as effective as the creation and enforcement of private property rights. But they faced the risk, as seen in many other countries, of creating monopoly rents for some privileged group. The creation of such rents will not be anywhere near as important when the government is "strong" as when it is "weak" (when it is unable to take away the rent as easily as it creates it). The differences between "strong" and "weak" states is a point I will return to later.

I believe that the basic difference between my understanding of what is important in development and the main thrust running through the background papers is in the approach to what is described as "correcting market failures". I believe the main duty of the government is to look for ways to make the market work more or less effectively. Not perfectly. We cannot expect markets to work perfectly. And we know now that governments do not work perfectly - certainly not in undertaking productive activities and, as we are now realizing, not even in the provision of welfare services. If the government has to perform the function which the market is falling to perform well, then it should be a temporary solution and the government should look for ways to get the market to work. Creating an appropriate set of institutions is part of that function. Experimentation with institutions, as has happened in the NIEs, should also be seen as a necessary part of the process.

What do I believe we have learned about important issues of policy-making for developing countries and countries in transition? I believe we know that the following issues matter most: (1) initial economic conditions; (2) the political/cultural situation; (3) the types of policies being reformed; (4) sound stable macroeconomic policies; (5) capital accumulation, particularly human capital accumulation; (6) the quality of investment is as important as the quantity; (7) openness to trade and capital, including foreign direct investment, which brings with it access to technology and markets; (8) financial liberalization (the importance of mobilizing and intermediating savings, within the framework of market-based interest rates, is a relatively recent realization); and finally (9) allowing entrepreneurship to flourish.

I will discuss briefly a few of these points: first, initial conditions. We know that the relatively high levels of literacy and low inequality were important in the NIEs. Their limited involvement with import substitution policies was also important, as it meant that they did not start with high taxation of agriculture. For those beginning with a large agricultural sector it was important for agriculture to be a leading sector, supported by research and extension, to generate savings and release an elastic supply of labour for the industrial sector to bloom.

The strength of the state is obviously important in terms of implementation of economic reform policies. Weak states are seen as those unable to enact or sustain reforms, and are vulnerable to "capture" by interest groups and are corruption prone. States may also be seen as weak or strong *vis-à-vis* the power of the government and communities to raise revenues and undertake activities.

Macroeconomic policy reform appears to be relatively easy to implement, while microeconomic reform is generally difficult. The ease of implementation of macroeconomic reform has to do in part with the indirect nature of its effects. Exchange rate policy changes may have a much stronger impact on industry than trade policy, yet they elicit much less concern. Effects of microeconomic reforms, such as trade reform or reform of state-owned enterprises, are more obvious on wages and employment, and therefore attract much more attention. In such cases, there is much more demand for "local participation".

I shall now to illustrate the usefulness of the policy lessons for two developing countries in which I have a close interest, Papua New Guinea and Viet Nam - very different countries in terms of initial economic conditions and the power of the state.

Papua New Guinea is resource-rich in terms of oil, minerals and agriculture, with about 85 per cent of its population living a semi-subsistence existence. Its educational level is low. Its government is weak, with its main revenue source being resource rents. In terms of service delivery, particularly at the community level, it has little capacity and little power. Papua New Guinea's institutions are relatively new and largely bequeathed by previous colonial rulers. It has a poorly developed physical infrastructure in a geographically very difficult environment.

Viet Nam also has a large percentage of its population in agriculture. However, it is in a better position in terms of its educational level. The state is extensively involved in production activities and is seemingly strong. Its institutional and physical development is poor, however. Like Papua New Guinea, it has a little developed financial sector, particularly in the rural areas, yet with strong government controls over interest rates.

Both countries have to invigorate their agricultural sectors. They need to have sustained growth in agriculture which can only come about through government investment in research and extension, as well as the creation of a physical infrastructure, so that inputs and outputs can flow freely. Papua New Guinea is in the midst of a minerals development boom. It should follow Indonesia's lead in using its mining rents to develop its physical infrastructure and improve the educational level of its population across the board. Unfortunately, it has been reluctant to do either, with public investment in physical infrastructure and expenditure on health and education declining recently. It is experimenting with its institutions, however. Recently, the relationship between the central and periphery governments was changed extensively. Law and order is a very important problem: one of the main barriers to domestic and foreign investment. The problem is essentially due to the government not performing a basic function in the enforcement of property rights.

Because Papua New Guinea's central government seems so prone to capture, I cannot see it effectively copying the kinds of state involvement which some see as having been so beneficial in the NIEs. Industry support has been very discriminatory, and microeconomic reform has proven very difficult. Hence, the deliberate creation of rents is something I would strongly recommend against. While its wages are relatively low, its unit labour costs are high because its productivity is very low. Hence, it is not attractive for foreign investors wishing to set up an export activity based on low-cost labour.

Domestic investment is proving difficult because savings mobilization and credit intermediation are poor. A large part of the problem is that land is owned under customary law, i.e. by clans, not individuals. Hence, it cannot be used as collateral for raising loans. The use of a development bank has not been successful. It has been "captured" by politicians for their own purposes. What seems appropriate for the promotion of small, rural-based industries is micro-enterprise credit schemes linked with vocational training activities. These are not activities which the government should undertake. But it can provide an encouraging environment for non-governmental organizations to undertake them.

The East Asian experience detailed here has not emphasized how difficult, yet how important, is good management of natural resource development in commodity-dependent economies. Papua New Guinea has been suffering the all-too-common problem of fiscal indiscipline - and widespread corruption - during a resource boom. Besides a general improvement in the state-society relationship, some institutional innovation could be useful. I have suggested the adoption of an institution along the lines of the German Economic Council, which reports to the parliament on the government's handling of fiscal matters. This should bring about a desirable transparency to fiscal policy and its implementation.

Viet Nam is undergoing a period of rapid growth, but under restricted conditions. Its agricultural sector has done well after farmers were given more secure property rights to land. The same security of property rights to land and to profits does not yet exist in the remainder of the economy, however. The government is developing its economy in the wrong direction - towards capital-intensive, heavy industries. What is needed, with the potential for 20-30 million labourers to come out of agriculture, is the development of labour-intensive industries. Hence, FDI should be liberalized, interest rates should be deregulated, and the financial sector should be reformed. The labour market should also be liberalized. To tell the Government of Viet Nam at this stage that the priority of a "clever government" should be to manipulate through its industrial policy would be an entirely wrong signal. Like China, Viet Nam has not gone very far in creating a viable legal framework for the development of its industrial sector. Focusing on the creation and enforcement of property rights in this sector is presently much more important than creating and withdrawing monopoly rents for selected industries.

In summary, I see the "clever government" emphasis of the background papers as being a wrong emphasis fo. countries in the circumstances of Papua New Guinea and Viet Nam. Those kinds of factors may have been important in East Asian economies, although I have some reservations about drawing that conclusion. But where the state-society relationship is weak, where the emphasis is on distribution rather on growth, where institutional development is poor - particularly where so much more needs to be done to develop private property rights and contract enforcement mechanisms, I would rather see the emphasis on different government functions. ■

Comments

*Mjedo L.C. Mkandawire**

There are many lessons sub-Saharan African countries (SSACs) can draw from the rapid economic growth experience of the newly industrializing economies (NIEs) of East Asia. For that purpose, SSACs have to study in detail the experiences of the NIEs, then select what may be applicable to them. However, even before they conduct detailed studies, some few broad lessons seem already obvious.

I. Government intervention

One of the obvious lessons is that the rapid growth of both first- and second-tier NIEs has owed a lot to the visible hand in the form of varying degrees of government intervention. Such intervention has also been required in SSACs in view of several unfavourable circumstances prevailing there. Firstly, the majority of the people are very poor and live in rural areas, mainly as small-scale farmers. Apart from their subsistence activities and the little produce they sell for cash, they know very little of modern domestic and foreign trading (in which their produce is also involved), the complexities of finance and other aspects of the formal sector. In these very poor, vulnerable conditions, prospects of meaningful improvement in their standard of living cannot be largely left to the invisible hand of fully liberalized competitive market forces, as they do not recognize and are not sympathetic to the poor. Nor should the future progress of non-agricultural small-scale enterprises (SSEs) be left largely to such market forces, which are not sensitive to the fact that SSEs face considerable comparative disadvantages in many crucial areas, including access to formal sector credit, appropriate technology, foreign trade information and business-skills training. Left alone without direct and purposeful government intervention, these small-scale agricultural and non-agricultural operators can be further marginalized and left out of the main stream of economic progress. And if after some years market liberalization does not do the trick, it will be nationally more costly and administratively more complex to correct market failures and bring back these small operators into the main stream.

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Secondly, inadequate foreign exchange is a major constraint to the economic development of nearly all SSACs, as their export earnings fall considerably short of their import requirements, a large part of which are capital goods and raw materials for industry as well as farm inputs. But the foreign exchange shortfalls should not be covered continuously by foreign loans and grants. National efforts have to be deliberately mobilized towards the objective of becoming self-reliant in generating foreign exchange. As a result, export promotion deserves considerable attention. All this cannot be initiated and coordinated by private enterprises themselves, whose major objective is to make money regardless of whether it is from exports or domestic sales.

Thirdly, and more broadly, for the sub-Saharan and other poor countries, to move up to higher levels of economic development they obviously have to grow much faster than the rich countries. If they do not, their relative position in the international environment will not change. To run faster, their national efforts have to be purposefully marshalled and encouraged, which obviously cannot be left largely to the invisible hand.

It is clear from the foregoing that government intervention in the early stages of industrialization in SSACs cannot stop at only formulating policies aimed at macroeconomic stabilization and creating an environment conducive to private sector initiative, i.e. creating a market-friendly environment. Rather, the government has to go further by performing a range of developmental tasks which the private sector is not strategically placed to perform.

For government intervention to be effective in a wide range of areas including finance, trade, the development of appropriate technology and manpower, there must be commensurate administrative capacity. The lack of it should not justify relegating some crucial developmental responsibilities to the invisible hand, since such capacity can be built, although it may take time. Further, there must be good cooperation between the government and private sector, mindful that such cooperation is not abused to serve parochial interests so as to avoid creating a concentration of power and wealth at the expense of national objectives. Even the good interventions that SSAC governments have already carried out may be further improved upon by blending with good lessons to be drawn from the NIEs of East Asia and elsewhere.

II. Initial conditions

Another obvious broad lesson to be drawn from the success story of the Asian NIEs is that existing initial conditions are crucial in determining in which areas the government should intervene, and with what policies and incentives during the early stages of industrialization. Among the most important conditions is political, social and macroeconomic stability. The recent transition from single-party to multiparty democracy in several SSACs has induced some degree of frustration among the electorate, as their rising economic expectations created by political campaign promises have hardly been met. In most cases, frustration has led to social and labour unrest. Another important condition is the availability of natural resources. The availability of cheap labour also assumes considerable importance in the initial stages of SSAC industrialization through labour-intensive industries. This is particularly important, when the local capacity to absorb technology from advanced countries is low. Also important is the extent to which the land policy is conducive not only to industrial development but also to activities of small-scale farmers. There are other internal conditions, which vary in accordance with the internal and external conditions of every country.

III. Domestic savings

Let us now focus on domestic savings and later turn to the related aspect of credit allocation. A quite striking phenomenon among East Asian NIEs has been the high rate of domestic savings and the resultant financing of increasingly large proportions of domestic capital accumulation/investment in productive activities, including the crucial export sector, out of their domestic savings. This phenomenon should be of considerable interest to SSACs, where the domestic savings rate is generally very low, and consequently very large proportions of domestic capital formation are financed from foreign capital inflows. It would have been better if substantial portions of capital inflows into SSACs were foreign direct investment (FDI), accompanying the inward transfer of technology. FDI has played an important role in several Asian NIEs.

Business savings: As explained in papers prepared for this Conference, Asian NIEs have used a variety of incentives to boost corporate profits above their free-market levels, including favourable taxation, trade-related selective policies of protection, controls on interest rates and credit allocation, and managed competition through such methods as encouraging mergers. This has been coupled with severe restrictions on luxury consumption. Apart from taxation, many of the foregoing types of incentives may hardly be implementable now in most SSACs, in view of the market liberalization programmes being carried out with the support of the Bretton Woods institutions. SSAC governments would therefore have to do a lot of homework to create alternative incentives in order to considerably boost corporate profits in their economies and to induce businesses to retain increased proportions of profits and re-invest them in their activities, especially the exportables sector. Here, there is the danger of capital flight and reduced foreign investment inflows if political, economic and social stability is not sustained. The situation would be worsened if instability emerged in a country whose liberalization programme has removed exchange controls even on capital flows.

It should be noted that in some SSACs the volume of sales, and consequently the profit levels as well as retained earnings of some import-substitution manufacturers, are partly constrained by consumers preference for imported goods, even though the quality of imported products is no better than the local substitutes. Then the government, in cooperation with the business community organs such as the chambers of commerce and industry, must make efforts to reverse the preference, thereby improving the demand for local products as much as possible.

Government and parastatal savings: How well have governments and parastatals in SSACs carried out the required promotion of the habit of saving through reducing the consumption of luxury goods, such as expensive cars for ministers, senior civil servants, general managers and other senior officials of parastatals? For if they are not exemplary in this regard, how could they expect private enterprises and households to reduce their consumption of luxury goods?

Rural savings: SSAC government efforts should continue to be directed at encouraging the habit of financial saving among rural households, no matter how small the savings out of their low incomes may be. Where the rural branches of deposit-accepting financial institutions are inadequate, what incentives can the public authorities give to such institutions to expand their rural-branch networks in view of the fact that such networks are usually costly to operate because of transport and other factors? What incentives can such financial institutions be given to avoid raising minimum balances on deposit accounts to levels which are so high as to discourage small income earners from saving? It must be recalled that it is expensive for the financial institutions to service interest-earning deposit balances at below certain levels.

IV. Credit allocation

Agricultural and non-agricultural small-scale operators in both rural and urban areas do not have access to adequate credit from formal lending institutions, especially the long established commercial banks reputed not to be user-friendly. Some of their credit requirements are met from informal financial institutions/agents of various types. However, many of them may not be equipped with adequate loanable funds to meet the credit requirements of their clientele. In addition, their loanable funds are likely to be of short term in nature, on the basis of which they can hardly extend medium- to long-term credit for capital formation.

Medium- and long-term institutional credit is in considerably short supply not only for small-scale operators but also for large-scale enterprises in most SSACs, as their capital markets (and money marks) are still weak and fragmented. Meanwhile, commercial banks account for large shares of total deposit resources in these economies, but most of them concentrate on short-term lending. Are such commercial banks not overemphasizing the risk of lending long- against short-term deposits, when some other financial institutions, particularly building societies, are doing precisely that in the same financial environment? Should the public authorities use moral suasion or give incentives to such banks to increase the share in their portfolios of medium- and long-term credit?

One well-known reason why commercial banks are not lending much to SSEs in SSACs is their perception that these enterprises are risky. How much do governments guarantee borrowing of these enterprises? For those enterprises/sectors which need support but are considered risky by banks, how much room is there for supporting them through directed credit following the liberalization of financial markets, which is leading an increasing number of SSACs away from the use of direct to indirect monetary policy instruments?

V. Conclusion

In view of several quite unfavourable conditions in SSACs - some of which we have argued may not be improved if they are largely left to the invisible hand - there appears to be a strong case for not reducing government intervention in these countries. This is particularly so with respect to the vulnerable and marginalized sectors, namely small-scale farmers and non-agricultural SSEs. These sectors, whose members form the majority of the people in SSACs, are in a relative position of weakness, which raises doubts as to whether liberalization of the markets can help to accelerate their progress. There is the great danger of marginalizing them further, thereby widening dualism in SSACs and defeating the whole objective of economic development. Therefore, even if GDP rises fast on account of the value added of large-scale enterprises, the welfare level of the majority may remain stagnant. One of the critical areas for intervention is finance. There is need to promote domestic savings with a view to increasing short-term credit to the marginalized sectors as well as medium- and long-term credit to these and other sectors. ■

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PANEL

Chairperson:	*Roger Lawrence** Deputy to the Secretary-General of UNCTAD, Geneva, Switzerland
Panellist:	*J.-H. Jeong** Senior Research Fellow, Korean Economic Research Institute, Seoul, Republic of Korea
Panellist:	*J. Ocampo** Director, Department of National Planning, Bogota, Colombia
Panellist:	*Kazumi Goto* Managing Director, Research Institute of Development Assistance, Overseas Economic Cooperation Fund, Japan
Panellist:	*B.L. Das* New Delhi, India. Former Director, International Trade Division, UNCTAD, Geneva, Switzerland
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* Written statement unavailable.

Report of session 3: Policy initiatives for marginalized sectors

*Kazumi Goto**

I. Introduction

To begin with, please let me quote a conversation between Alice and the White King in Lewis Carroll, *Through the Looking Glass and What Alice Found There*, in order to describe the current state of the discussions on the lessons from the East Asian miracle.

> *"I see nobody on the road", said Alice. "I only wish I had such eyes", the King remarked in a fretful tone. "To be able to see Nobody! And at that distance too! Why, it's as much as I can do to see real people, by this light."*

East Asia, now regarded as the world's growth centre, has achieved rapid economic growth. This reality has sparked a new policy debate over whether development should be led by the government or the market, specifically concerning the role of the "guiding hand" of the former and the "invisible hand" of the latter in development management.

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The neoclassical economic view of development management, which emphasizes the market mechanism, has tended to prevail in this debate. Recently, however, there has been growing interest in the development mechanism (i.e. selective government intervention) that triggered the so-called "East Asian miracle". East Asia's economic success stories show not only the importance of weighing the three types of failures in economic policy management - located in the government, the market, or their coordination - in the light of conditions in each country, but also the need to build strategic management capacity (i.e. adaptability, flexibility, and pragmatism) into each country's socio-economic system, as well as the potential to apply the East Asian approaches in other regions.

This situation suggests that development economics may once again become an interesting facet of development studies. How can we go beyond the East Asian miracle? What lessons can be drawn from the East Asian miracle? I would like to try to pinpoint five lessons for each from the following three aspects: (1) general lessons for development management; (2) the role of government in economic development; and (3) practical prescriptions for the effective use of policy-based directed credit.

II. General lessons for development management

What are the major lessons for development management in general? The appraisals on structural adjustment and economic performance in East Asia by those in the fields of development studies and development economics have provided us with five lessons which are pointed out as necessary for successful development management. These lessons, learned from practical experience over the last 40 years are as follows: (1) there is a need for an appropriate combination of stable macroeconomic management, economic and industrial policies with an adequate incentive system as well as the development of infrastructure facilities and human resources for successful economic development; (2) development models must be appropriate for individual countries; (3) there is a need to integrate structural adjustment programmes by stages into medium- and long-term development plans; (4) organic cooperation should be established between the market mechanism and the public sector's institutions; (5) the formation of a socio-economic system that has a strategic management capability as their trinity of adaptability, flexibility and pragmatism is required.

Moving between an "incomplete" government and an "incomplete" market, the developing countries are aiming for autonomous development to take on structural changes in their socio-economic systems. It is in the formation of a strategic management capability based on theory, methodology and practice that we find the frontier at which further intellectual work is expected in development policy theories that manage the interaction between development and aid.

III. Role of government in economic development

Since its publication in the autumn of 1993, the World Bank report *The East Asian Miracle* has attracted considerable attention both for scholars and policy makers in Japan and overseas. Today, not only neoclassical economists but also structuralists and even interventionists are all rushing to cite East Asia's economic success as proof of the validity of their *own* theories about development strategy. It even seems that the East Asian miracle has become a kind of "intellectual public property" for the world of development studies, including economics.

There was widespread agreement concerning the importance of "getting the fundamentals right". Later, it became apparent, however, that there are a number of viewpoints differing from the approach taken by the World Bank in areas such as: (1) the role of government in economic development and responses from the public sector (including political leadership, diversity of development, and importance of social mobility and social integration); (2) the effectiveness of industrial policy (including policy-based directed credit); (3) the institutional aspects of economic development; and (4) the applicability of the East Asian experience to other regions.

According to the "Follow-up Survey on Evaluations and Criticism of the World Bank Report" made by the Research Institute of Development Assistance (RIDA) of the Overseas Economic Cooperation Fund (OECF), for example, the opinions of informed persons from England, Asia, and other regions on the roles of government in economic development may be summarized in the following five points: (1) the governments of developing countries must not stop with the establishment of fundamental conditions; (2) they must themselves lead the course of development from within; (3) when policies prove to have no effect, they must have the adaptability to change policies with pragmatic determination and flexibility; (4) they must play an important role in creating institutional foundations for effective implementation of policies; and (5) learning from the lessons of the East Asian experience, it is essential that there be a widely shared awareness concerning the creation of social foundations to maintain rapid but equitable economic development through great efforts by the governments of these countries towards the formation of institutional capabilities.

The conclusion that emerges from our discussions is that an approach based on the concept of "marginalized sectors" provides a perspective that is very interesting for the development of the debate over the East Asian miracle in four types of interaction.

First, in terms of the government's role and the response of the private sector, how can the government form a national consensus towards development goals and evoke a positive response from farmers, small business operators and others? Second, in terms of industrial policy, how can small-scale finance and two-step loans be used effectively as policy-based financial support tools? Third, in relation to the institutional aspects of economic development, what methods can be used to overcome such problems as transaction costs? Fourth, in terms of applicability to other regions, how should governments approach the endogenous development of systems and the formation of strategic development capabilities?

While these four issues are all interrelated, each can be viewed as an important policy priority in its own right. When undertaking a factor analysis of the East Asian miracle, it is necessary to focus in particular on the institutional basis for shared growth.

In relation to specific approaches to the achievement of development goals, the World Bank report refers both to education and to development strategies designed to foster agriculture and small business, which form the foundations of society. In relation to agriculture, it ranks agricultural support measures alongside land reform. As far as small business is concerned, the report recognizes that, while growth is generally driven by market forces rather than by government intervention, governments in some countries have supported small- and medium-sized enterprises by providing preferential finance and establishing special support services.

To take this notion further, it would be reasonable to conclude that another characteristic of the East Asian miracle is the fact that although governments have pursued export-oriented growth strategies, they have positively incorporated agriculture and small business enterprises into their development policies, instead of marginalizing such sectors.

As pointed out by Janet Farooq (ESCAP) in the discussions, on the other hand it should be noted that exposure to the disciplines of the external market is very useful in making sure that government policies, including those selectively supporting certain sectors, are efficient and non-distortionary. The knack of success seems to lie in how to do this and cope with the needs of the marginalized sectors and maintain macroeconomic balance at the same time. This is a very tall order for any government.

IV. Practical prescriptions for the effective use of policy-based directed credit

How can policy-based directed credit to support marginalized sectors be used effectively? It seems that five practical lessons may be drawn from the case studies on Thailand (Pittayapol Nattaradol, BAAC), Indonesia (Soekarno Wirokartono, National Development Planning Agency/Bappenas), and Japan (Mitsuhiro Kagami, Institute of Developing Economies), in addition to the following cases examined in my introductory presentation. These lessons are as follows: (1) from the viewpoint of the effectiveness of policy-based directed credit, since this tool is introduced to achieve future policy objectives, these objectives must be realized together with other policy measures being implemented concurrently; (2) policy-based directed credit must be introduced in such a way as to direct a country's financial market towards healthier development based on market principles (including the liberalization and internationalization of financial markets in the developing countries) and to contribute to the resulting effective allocation of resources (or at least not to disrupt effective resource allocation); (3) from the viewpoint of the achievement of the policy objectives of policy-based directed credit, the adequacy and suitability of policies as the prerequisite of policy-based directed credit must be ensured; (4) from the viewpoint of the relationship between policy-based directed credit and the development of the financial market as a whole, the existing financial markets in developing countries should be fostered, subject to such requirements as the prevention of capital flight and promotion of domestic savings, and against a backdrop of keener international competition for extremely speedy adjustment; (5) from the viewpoint of the management of policy-based directed credit under market principles, the selection of end-users and target projects for financing (or decisions about resource allocation through policy-based directed credit) should be free from arbitrariness and political influence, and should also be effected in line with the policy on which the policy credit is based, and in conformity with rules previously established on the basis of economic rationality (that is, fairness and neutrality). Only then can rent-seeking activities and corruption be prevented. Indispensable for this purpose are assessment by intermediary financial institutions based on the characteristics of policy goals and final end-users targeted by the policy, and the establishment of a system to safeguard claims and support these efforts.

Thus, policy-based directed credit is applied at the interface of contact between macro- and micro-economies, between the financial sector and the policy-target sectors, between the government and the private sector, between efficiency and equity, between economic and social developments, and between monetary and fiscal policies. If the conditions for the efficient and effective management of a policy-based directed credit system are in place, the way will be paved for the applicability of the system to regions other than East Asia.

V. Concluding remarks

From the perspective mentioned above, how shall we be able to go beyond the East Asian miracle? One of the most important lessons would be the need to form the strategic management capability to make choices from diverse and complex options concerning development policies in the course of seeking organic cooperation between the government and the market in both areas of domestic and international systems. The importance of this lesson has been demonstrated by the experiences of countries that have developed successfully, including East Asian ones. The capability is two-fold: the ability to learn from practice, and the ability to modify policies if necessary. Because of this capability, the system in question incorporates three elements: adaptability, flexibility, and pragmatism.

In the world of development, the employment of proper policies is less important than the construction of economic and social systems that enable people to recognize and adopt such policies at their own discretion. Without such internal efforts, a country cannot be expected to achieve development, and assistance from the aid-providing side is unlikely to yield the desired effect. Awareness from such a viewpoint leads to the realization that it will be necessary to develop analytical models to explain how the development process may be controlled and managed. It also suggests the need to redefine development from this viewpoint in terms of whether development means "growth", "elimination of poverty" or "structural transformation". A commonly observed characteristic in the process of the shift from a traditional exchange economy to a modern market economy is the "structural transformation" of nations. The problems related to "development" in this process should be viewed as problems of the creation of, or transformation into, flexible, useful and practically effective economic and social systems.

The problem of the "replicability" of the experiences evidenced in the East Asian miracle to other regions should be discussed not for the purpose of recommending the employment of similar policies but of learning practical methodologies for the development of the capabilities needed for dynamic economic and social systems able to seize opportunities by adapting to a constantly changing world market. The World Bank report *The East Asian Miracle*, after enthusiastic studies of the lessons offered by the East Asian experience of development, fails to show a sufficient and deep understanding of wider institutional aspects. The major reason is the failure to distinguish between policies and economic and social systems, in addition to its bias towards free market principles. As advocated in my presentation, at the root of discussions about development management in the developing nations is the belief that development must be autonomous.

Lastly, I should like to emphasize that East Asian countries differ from other developing economies in that they have made effective and discretionary use of comprehensive economic cooperation (i.e. aid, investment and trade) from Japan and other countries, and that they have established many institutions and fostered the above-mentioned management capabilities through their *own* sustainable development efforts. Without such self-help efforts, assistance from any foreign country or international organization is unlikely to yield sufficient benefits. Without a firm will to develop itself, no country can be constructively helped in its efforts to develop the capabilities to realize its development.

The formation of strategic development management capability, consisting of the theory and practice that enable developing countries to implement reforms of their economic and social systems in order to achieve autonomous development, is a frontier that will require intellectual effort in terms of development management policies, and also in terms of new work in the fields of development studies, including development economics. We are thus seeking a new frontier in development studies, one that will take us beyond traditional economics and enable us to conduct comparative studies of institutions for development management in relation to governments and markets in developing countries. We see the East Asian miracle as a "knowledge treasure-house of information" that will revitalize development economics.

Finally, please let me close my presentation by quoting again from Lewis Carroll, *Alice's Adventures in Wonderland*, in order to search for a new frontier of development management in East Asian miracleland.

> *"Consider your verdict", the King said to the jury.*
> *"Not yet, not yet!" the Rabbit hastily interrupted.*
> *"There's a great deal to come before that."* ■

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Report of session 4: Policy options in a globalizing environment

*B.L. Das**

In the session on "Policy Options in a Globalizing Environment", important contributions were made by Murray Gibbs of UNCTAD, Jan Kregel of Bologna University, Walter Cabrera from ECA, Bakhtior Islamov of UNDP, Uzbekistan and Martin Khor of Third World Network.

Mr. Gibbs elaborated on the trade policy options which are available to the countries in this region in the light of the Uruguay Round Agreements. Professor Kregel discussed the impact of the dynamic developments in the financial services sectors. Mr. Khor drew the attention of the group to a new and emerging issue, i.e. the proposal for a multilateral investment agreement and the possible implications for the development process in this region. Messrs. Cabrera and Islamov described the trade and development situations respectively in African countries and the countries in transition from centrally planned economies to market economies.

Attempt is not made here to summarize these excellent presentations. In fact, any such summary is not necessary in this presentation. However, some salient features need recalling. The countries in Africa and those in transition need investment and technology to take advantage of the opportunity provided by emerging globalization in international trade. In seeking investment, one has to guard against opportunities which are of a fickle nature; for example, even foreign direct investment may, in some conditions, be less permanent than what it appears at first sight. The new proposals for a multilateral investment agreement may put a very high degree of constraints on developing countries in pursuing their path of development suited to their particular situations.

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Various papers presented at the Conference and discussions thereon have left no doubt that governmental policies and measures provided a necessary and significant framework in which the trade and industry operated to take the maximum advantage of the opportunities. If governments wish to continue with their positive role in future and if other governments wish to adopt this model, it is important to examine the emerging constraints and flexibility. And in this regard, one set of significant factors is the disciplines contained in the WTO Agreement.

The use of domestic and export subsidies as instruments for channelling resources into specific sectors of industrial production and exports may not be as easy as it was earlier. Although the least developed countries and some other developing ones with a per capita GDP of less than US$ 1000 per annum still have considerable flexibility in this regard, while others find themselves constrained. However, subsidies which are not prohibited may be used to the extent that these do not cause injury or prejudice to other countries. What is needed in this area is a close monitoring of the trend of exports of sensitive products to specific markets and the conditions of the particular sector of industry in important importing countries. One should be able to see the early signs of injury or prejudice to the industry in the importing country and modulate the subsidies accordingly.

Considerable flexibility continues in the area of investment and technology. Important conditions on investments which a country cannot impose now are: the compulsory use of domestic products, foreign exchange balancing by linking the outflow of foreign exchange to inflow, and stipulation of compulsory use of the product in the domestic market. There is no restriction on the transfer of technology as a condition for investment or on limitations regarding ownership or equity holding.

In the areas of services and intellectual property too there is a good deal of flexibility. In the services sector a country may make commitments based on its own perception of advantages, as the commitments here depend on bilateral and plurilateral negotiations in the framework of the Agreement on Services. Several major industrialized countries have made some concessions regarding opening up their services sectors. Developing countries in this region may be able to take advantage of these opportunities. What is necessary here is to examine the schedules of these countries carefully and to identify areas of export interest.

The Agreement on Trade-Related Intellectual Property Rights (TRIPs) does put countries with a comparatively low level of scientific development at a disadvantage, in the sense that working around a patented invention or developing a new process through reverse engineering will now become extremely difficult. But this Agreement contains several areas of discretion for a country and there is some scope for reflecting development objectives in the implementing legislation. Countries should try to identify these areas and take advantage of permitted flexibilities.

In general, there are several areas in the WTO Agreements where flexibilities exist. Governments should appropriately adapt their policies and measures in these areas, using their discretion. A prudent and well modulated use of the policies and measures covered by the new disciplines of the WTO Agreements can help governments to continue with several important instruments and adopt new instruments in pursuit of their developmental goal. ■

Report of session 5: Policy lessons

John Toye *

What policy implications does the development experience of East Asia have for countries in other regions seeking to promote their own development? Are there policy lessons that can be learned and applied, and if so what are they? These were the central questions addressed by the panel dealing with policy. In reporting the panel's views on the questions, it may be helpful to break them down into three distinct but related sub-questions.

First of all, does the East Asian development experience indicate any ideal set of policies for rapid economic growth with equitable distribution? Second, do any domestic constraints on policy-making capability exist that would render the ideal set of policies very difficult or impossible to implement in countries outside East Asia? Third, are there any international or regional constraints that now prevent fully capable national governments in other regions from executing the same ideal policies that were used in East Asia in the past?

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I. Does East Asian experience suggest ideal development policies?

Mr. Akyüz approached this question by reflecting on the value added to the general understanding of East Asian development by the UNCTAD project, which was the focus of the Conference. This research endeavour had been undertaken without preconceived positions, and not in any kind of competition with others exploring the same questions. It had, however, concluded that an active government development strategy and institutions capable of carrying it out were the crucial determinants of East Asian economic success. Previous analyses of the process of development in East Asia had been weak. Success was caused neither by "getting prices right" nor by "getting prices wrong", i.e. by permitting selective price distortions. The heart of the matter was the establishment of certain types of relationships between government and business, as explained in a previous session by Professor Evans.

These relationships were intended by the government to achieve certain linkages in a dynamic economic process. New national technological capabilities had to be embodied through a continuous process of new investments in new industrial sectors. Each investment should generate profits for the business making it. In the short term, government assistance, in the form of tariffs, interest rate subsidies, etc., was required to guarantee these initial profits. Such assistance was not open-ended, but geared to the firm's achieving a target export performance over a limited time period. The profit/investment nexus then had to be maintained by fiscal incentives for the retention and reinvestment of profits, and the deliberate closure of channels by which profits could leak into consumption and speculation. This "forced" reinvestment of profits both deliberately speeded up the transition from manufacturing potato chips to manufacturing computer chips, and brought about a more equal distribution of income than would otherwise have occurred. Government-business relations were organized to ensure the negotiation and management of this continuous accumulation process.

Professor Duncan believed that there were dangers in putting too strong an emphasis on policies of physical capital accumulation and government intervention in physical accumulation. Why, after seeming such a success from 1930 to 1960, did the former Soviet Union fail? It accumulated a huge amount of physical capital through elaborate forms of government planning and controls, but eventually the marginal productivity of its new investment fell to zero. Government intervention may be justified only by the existence of specific instances of market failure. Where such failures occur, the task of the government is to create appropriate private property rights. Where private property rights cannot be legislated, the task of the government is to provide public goods. In the East Asian case, governments went beyond the creation of property rights and the provision of public goods. They undertook additional activities and in so doing they created rents. This is dangerous because only unusually strong governments can subsequently remove the rents that they create.

Governments should focus their efforts on getting markets to work better. They have to remove distortions that inhibit development, such as the heavy taxation of agriculture. They have to manage the political situation so that they can proceed with measures that will bring about macroeconomic stability and microeconomic liberalization. The latter is generally more difficult than the former, but the liberalization of the financial sector is of the highest importance if development is to take place. Capital accumulation is an issue for governments, but it is human capital that needs most emphasis, and for both physical and human capital the concern should be for the quality of investments rather than the quantity. Overall, the role of the government is to create an environment in which entrepreneurship can flourish.

The conditions in both Papua New Guinea and Viet Nam suggested that this was the right set of policies for their development. In the former educational levels were low, the physical infrastructure was poor, land remained in clan ownership, law and order was not adequately enforced and financial intermediation was weak. In Viet Nam, although educational levels were good, physical infrastructure was poor and property rights in land were limited. In addition, there was still a marked bias in investment towards heavy industry and there were constraints on the inflow of foreign direct investment (FDI). Both countries needed to re-invigorate their agricultural sectors and extend property rights in land. Papua New Guinea should invest more of its mineral rents in education and infrastructure and encourage NGOs to set up micro-credit schemes. Viet Nam needed to remove its heavy industry bias and liberalize its FDI restrictions. In both countries it would be wrong to encourage clever government schemes to try and accelerate the pace of industrial development.

Dr. Jayawardena (from the floor) explicitly contrasted the policy approach that had emerged from the UNCTAD research project, placing strong emphasis on government/business initiatives to increase and channel investment into new sectors of manufactured exports, with the policy approach of the World Bank's *East Asian Miracle* study, which was close to that outlined by Professor Duncan. The clue to the link between these two approaches was to be found in remarks made by Mrs. Farooq at a previous session. The policy set recommended by the Bank may be necessary conditions for rapid economic growth with equitable distribution, but they are not sufficient conditions.

The key issue may, therefore, be one of timing and sequencing. If governments overinvest in human capital without moving on to a capital accumulation/export of manufactures strategy, they will generate only educated unemployment, as was the case in Sri Lanka. If they move to it before the necessary conditions have been fulfilled, the strategy will prove unsustainable. If the sequencing is well managed and the strategy is successful, a third phase of government policy will become needed to correct the elements of government failure that are inherent in it, as has already happened in the Republic of Korea since 1990.

Dr. Köves (from the floor) from Hungary stressed the importance of avoiding ideological confrontations between different policy approaches. There was a regrettable tendency - not always avoided in some Eastern European transition economies - for governments to veer from one ideological extreme to another, in the belief that a single policy package could indeed work miracles. This only led to popular disillusion. What was needed was much greater pragmatism in economic policy-making. A gradualist, step-by-step approach was likely to give better results.

Professor Rowthorn suggested that development policy had to be based on the fact that at the beginning of the development process a class of competent domestic entrepreneurs hardly exists. It has to be actively built up, as it had been over the last thirty years in the Republic of Korea. Flows of FDI could act as a partial substitute for domestic entrepreneurship. The problem with relying on FDI flows was that they are tiny in relation to the need. There is simply not enough of such flows to assist every country that wishes to develop.

II. Are there constraints on domestic policy-making capabilities?

Mr. Kifle addressed a series of questions on the relevance of the East Asian development experience to sub-Saharan Africa (SSA). Does SSA need to make a major change in the thrust of its governments' policies? Is the East Asian development experience replicable in SSA? If so, under what conditions? At present, the policy environment in SSA was strongly influenced by the stabilization and structural adjustment policy packages associated with lending by the international financial institutions (IFIs). A key component of such packages was the reduction of the role of the state in the economy. Governments' efforts were being re-directed towards ensuring macroeconomic stability, deregulation (especially of the trade regime) and investment in human resource development, and explicitly away from active industrial policies. But the growth record of SSA economies remained poor. The average investment/GDP ratio still hovered around 15 per cent, while the savings/GDP ratio was only 7 per cent. It seemed that the continuation of existing policies would not lead to any significant acceleration of growth.

New forms of state intervention would be required for accelerated growth. To say this was not a call for a return to the old forms of state intervention, which had very clearly failed. The East Asian development experience had shown that there were different and much more effective instruments of intervention than those which had been used, and abused, in SSA during the pre-structural adjustment era. The government had to form a genuine partnership with the business community in order to develop actively the high profit/high re-investment/high export nexus.

Some had expressed doubts about the capacity of SSA bureaucracies to manage these types of interventions. It was obvious that in some types of SSA countries the conditions for attempting their use were not in place. In countries like Somalia and Liberia, the state itself had collapsed. Here the only relevant question: was what form of society could survive? In other SSA countries, the state was still functioning, but had effectively been captured by interest groups within society. No one would recommend that these states should attempt active industrial policies just yet. However, such policies might be possible in South Africa, although it would be wise to wait and see whether favourable conditions consolidated themselves. The essential conditions for success were those of "good governance", when this term was interpreted to mean a functioning independent legal system and effective mechanisms of executive accountability, and not necessarily full democratization.

Mr. Mkandawire justified continuing government intervention in the economy on the grounds that SSA economies have to grow much faster than those of the already developed countries. This needs deliberate coordination of a country's economic efforts, something that will never be supplied by the private sector. The majority of the population are peasants, who cannot be left to the mercy of market forces. The present dependence on foreign loans cannot continue indefinitely, which implies that exporting will have to be much more actively promoted.

There are many tasks for the government to perform to improve financial intermediation in Malawi. Savings needed to be promoted by a variety of measures, such as tax incentives for retaining profits and official deterrents to the consumption of imported luxury goods. In rural areas savings could be increased if banks expanded their branch networks. At present the Post Office Savings Bank, which has the most extensive rural branch network and low minimum balance requirements, does not undertake lending, except to the government, while other rural banking institutions are still in the process of formation. There is also a problem on the credit side in that banks are unwilling to provide medium- and long-term credit. In these circumstances there is a case for the government to direct credit to particular sectors and areas in accordance with its development priorities, especially as these may be risky in the eyes of the banks. Examples are in agriculture, the export of perishable primary products and the activities of small- and medium-scale enterprises.

Dr. Chang (from the floor) believed that the tightness of institutional constraints on following an active industrial policy could be exaggerated. The initial conditions which prevailed in the Republic of Korea in 1948 had been extremely poor, both with regard to the levels of education of the population and to the quality and competence of the bureaucracy. Even today the bureaucracy of the Republic of Korea was far from perfect. Nevertheless, a very dramatic economic transformation had been achieved.

III. Are there international/regional constraints on replication?

Mr. Akyüz noted that one of the issues that had been taken up by the UNCTAD research project was whether the outcome of the Uruguay Round of world trade negotiations, now embodied in the rules of the World Trade Organization (WTO), had introduced new restrictions on national governments' freedom of action that would have the effect of outlawing practices used by East Asian governments in pursuit of their development strategies. If so, this would be a serious impediment to other countries following their example. In fact, WTO rules did not appear to be a clear-cut constraint of this kind. Rather, as had been explored in a previous session, it seems that, where the rules are very detailed concerning trade, investment and subsidies, they leave some room for manoeuvre, and where the principle is most draconian, as with intellectual property, the relevant wording is phrased most generally and vaguely. The issue is an evolving one, the outcome of which will depend in part on what legal positions developing countries themselves choose to try to defend.

The role of the regional context of East Asian development had also been investigated by UNCTAD research. What was the true meaning of the "flying geese pattern" of regional development? What was the precise nature of the interdependence between the flight of the "leading goose", i.e. Japan, and the flight of the "following geese", i.e. the second- and third-tiers of newly industrializing East Asian economies? One lesson emerging from the research is that the flying geese pattern was not simply a market-driven process, but involved considerable intergovernment cooperation. A second lesson concerned Japan, whose ability to continue as the lead goose must come into question as its economy has reached the point of maturity, which, if other OECD countries are any guide, implies slow growth and high unemployment. A third lesson was that, when the countries of a region are at different levels of development, much scope exists for fruitful South-South cooperation.

Professor Toye said that the flying geese theory clearly needed some refinement in the light of the earlier presentations of Professor Rowthorn and Mr. Kume. Japan had taken steps to encourage the reduction of its own national capacity in certain early stage and low technology industries, such as textiles. Professor Rowthorn had shown convincingly that nevertheless Japan had continued to provide a poor market for the manufactured exports of the East Asian countries which had increased their capacity in these industries. However, as had been argued by Dr. Panchamukhi, the deliberate and planned reductions in Japanese capacity had the effect of creating opportunities for those countries that were increasing their capacity to export to third country markets that Japan was vacating.

The rapid increase in Japanese FDI flows to other East Asian countries from the second half of the 1980s seems to have been a more reactive process, as suggested by Mr. Kume. The driving force was the revaluation of the yen after the Plaza Accord, which made the relocation of production very attractive to Japanese companies. This push factor was complemented by the important pull factor of the removal of many restrictions on the FDI entry by the governments of neighbouring East Asian countries. Thus the flight of the flying geese seems to have resulted from a combination of the intelligent anticipation of, and responses to, events, but not from executing an agreed master plan of regional cooperation.

If this is so, then what are the implications for other countries that would like to replicate the East Asian development experience? Will the absence of supportive regional influences act as an additional constraint on successful replication? Surely the answer must be "yes". It is much harder to be the lead goose than a follower goose. Japan took much longer to reach the same level of development that the Republic of Korea has now reached. The very cautious assessment by Mr. Kifle of the prospects for replication in Africa is well justified. In addition to the problems of lack of institutional capacity which he mentions, Africa at present has no lead goose, and it is still too early to say whether the new South Africa will prove to be one. This, however, is to move on to questions which a further phase of UNCTAD research could very usefully investigate. ■

ANNEX I

List of participants

International

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